SOUTH EASTERN KENYA UNIVERSITY

UNIVERSITY EXAMINATIONS 2017/2018

SECOND SEMESTER EXAMINATION FOR BACHELOR OF COMMERCE AND BACHELOR OF ACTUARIAL SCIENCE

DFI 202: FINANCIAL MANAGEMENT

17TH APRIL 2018 **Time 1.30-3.30PM**

QUESTION ONE (30 MARKS)

a) A firm expects to receive KES 240,000 per annum for a period of 4 years from a newly undertaken project. The firm's cost of capital is 12%. Determine the present value of this annual cashflow **(4 marks)**

b) Although profit maximization has long been considered as the main goal of a firm, shareholder wealth maximization is gaining acceptance amongst most companies as the key goal of a firm.

Required:

(i) Distinguish between the goals of profit maximization and shareholder wealth maximization. **(4 marks)**

(ii) Explain three limitations of the goal of profit maximization. **(6 marks)**

c) Mlolongo Limited wishes to expand its output by purchasing a new machine worth 170,000 and installation costs are estimated at 40,000/=. In the 4th year, this machine will call for an overhaul to cost 80,000/=. Its expected inflows are:

	Shs.
Year 1	60,000
Year 2	72,650
Year 3	35,720
Year 4	48,510
Year 5	91,630
Year 6	83,715

This company can raise finance to purchase machine at 12% interest rate.

Required: Compute NPV and advise management accordingly. **(8 marks)**

d) What is venture capital? **(4 marks)**

e) KK Ltd is an all equity firm whose Beta factor is 1.2, the interest rate on T. bills is currently at 8.5% and the market rate of return is 14.5%. Determine the cost of equity K_e, for the company **(4 marks)**

QUESTION TWO (20 MARKS)

(a) Explain why the weighted average cost of capital of a firm that uses relatively more debt capital is generally lower than that of a firm that uses relatively less debt capital. **(6 marks)**

(b) The total of the net working capital and fixed assets of Faida Ltd as at 30 April 2003 was Sh.100,000,000. The company wishes to raise additional funds to finance a project within the next one year in the following manner.

Sh.30,000,000 from debt

Sh.20,000,000 from selling new ordinary shares.

The following items make up the equity of the company:

	Sh.
3,000,000 fully paid up ordinary shares	30,000,000
Accumulated retained earnings	20,000,000
1,000,000 10% preference shares	20,000,000
200,000 6% long term debentures	30,000,000

The current market value of the company's ordinary shares is Sh.30. The expected dividend on ordinary shares by 30 April 2004 is forecast at Sh.1.20 per share. The average growth rate in both earnings and dividends has been 10% over the last 10 years and this growth rate is expected to be maintained in the foreseeable future.

The debentures of the company have a face value of Sh.150. However, they currently sell for Sh.100. The debentures will mature in 100 years.

The preference shares were issued four years ago and still sell at their face value.

Assume a tax rate of 30%

Required:

(i) The expected rate of return on ordinary shares. **(2 marks)**

(ii) The effective cost to the company of:

- Debt capital **(2 marks)**
- Preference share capital **(2 marks)**

(iii) The company's existing weighted average cost of capital. **(4 marks)**

(iv) The company's marginal cost of capital if it raised the additional Sh.50, 000,000 as intended. **(4 marks)**

QUESTION THREE (20 MARKS)

a) Discuss 4 key advantages and 4 key disadvantages of debt finance to a business. **(8 marks)**

b) Examine the key features of an appropriate capital budgeting technique. **(4 marks)**

c) A project costs 16,200/= and is expected to generate the following inflows:

	KES
Year 1	8,000
Year 2	7,000
Year 3	6,000

Compute the IRR of this venture **(8 Marks)**

QUESTION FOUR (20 MARKS)

a) Examine the importance of the concept of time value of money in financial decision making. **(5 marks)**

b) The following is the capital structure of Ngana ltd.

	KES
Ordinary Share Capital (Par KES 50)	160,000,000
Preference Share Capital (Par KES 50)	70,000,000
Debentures (Par KES 50)	54,000,000

Additional information

i. The shareholders of Ngana ltd expect earnings and dividends to grow at constant rate of 10% in future. The company has just paid dividends at sh.2.00 per share.
ii. The current market price of one ordinary share Ngana ltd is sh.40.00
iii. Treasury bond yields 6%. The return on the market is 7%. The company beta is 1.4
iv. New preference shares can be sold at Ksh.60.00 per share a dividend of 12 per share, and floatation cost of sh.6 per share.
v. Corporation tax rate is 30%
vi. The company pays all earnings as dividends,
vii. The company will sell 12% debenture with a maturity of 10 years at sh.45 per debenture. The par value of debenture is sh.50

Required:

Using market values; calculate the weighted average cost of capital (WACC) of Ngana Ltd. **(10 marks)**

c) Malikia Oyo borrowed KES 1,000,000 from Heshima Bank ltd at annual compound interest of 14% on the reducing balance. The loan was repayable in annual instalments over a period of four years. The instalments were payable at the end of the year.

Required

A loan amortisation schedule **(5 marks)**

QUESTION FIVE (20 MARKS)

a) With clear examples, discuss the meaning of the term agency costs. **(5 marks)**

b) Examine the various types of covenants that may be used to mitigate the agency conflict between shareholders and debt providers. **(5 marks)**

c) Nile Group of Hotels is considering the acquisition of Victoria Hotel at a cost of KES 200 million. The group of hotels cost of capital is currently 16% due to high gearing level. Victoria Hotel has no debt. As a result of the acquisition, the cost of capital for Nile Group of Hotels will drop to 12%. Total cash flows will also increase by 25 million per annum into perpetuity

Required:

i. Using Net Present Value approach, advice the management of Nile Group of Hotels on the acquisition of Victoria Hotel. **(5 marks)**

ii. If the acquisition was financed by borrowing so that there is no impact on gearing after acquisition, and the cost of capital was not reduced, advise the management of Nile Group of Hotels whether to proceed with the acquisition of Victoria Hotel. **(5 marks)**