KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2018/2019

SECOND SEMESTER EXAMINATION FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

BAC 815: FINANCIAL MANAGEMENT

DATE: Friday, 5th April 2019 **TIME: 5.30p.m-8.30p.m**

INSTRUCTIONS:

Answer all the questions

QUESTION ONE(13 marks)

a. Any investment to be undertaken will need to be assessed as regards its viability using an acceptable approach. Any appraisal method to be used to assess the viability of a venture must fulfill certain requirements:
Required: Explain four requirements that an appraisal method must fulfill
4 marks

b. The county government of Machakos is concerned about a key road that connects Machakos town to Mombasa road. Currently it costs sh.5, 000,000 per annum to maintain the road. If a new road is constructed using latest technology, no maintenance will be required for the first 5 years, then sh. 1,500,000 p.a. for the next 10 years and sh. 2,000,000 p.a. thereafter. Assume cost of finance to be 9.5% p.a

Required: As an MBA student of finance and using the information given only, assist the management of the county government to decide whether to continue with the current road or to put up a new road now. Show all the workings.
7 marks

c. Outline four limitations of the accounting rate of return (ARR) method of appraising new investment projects. **2 marks**

QUESTION TWO(20marks)

a. Outline four factors that could influence the capital structure of a company. **4 marks**

b. Malik Ltd is interested in measuring its overall cost of capital and has gathered the following data for the year 2019

Debt: The firm can raise an unlimited amount of debt by selling sh. 1,000 par value 8% coupon rate, 20 year bond on which annual interest payments will be made. To sell the issue, an average discount of sh.30 per bond would be given

Preference share: The firm can sell 8% preferred stock at its sh.95 share par value. The cost of issuing and selling the stock is expected to be sh. per share. An unlimited amount of preferred stock can be sold under these terms.

Equity: The firm expects to have sh.1,000, 000 of retained earnings in the coming year 2020. New shares can be issued at sh.62 each with a floatation cost of sh.2 per share. The growth rate is expected to be 6%. Expected dividend in the coming year is sh.6.

The company's estimate of optimal capital structure is given below:

	Sh. 000
Debt	30,000
Preference shares	20,000
Equity	50,000

The company tax rate is at 30%

Note: Maximum additional capital to be raised = [(retained earnings available)/(optimal equity proportion)]

Required:

i. Compute the specific cost of:
- Cost of retained earnings **2 marks**
- Cost of ordinary share capital. **2 marks**
- Effective cost of debt **4 marks**
- Reference share capital **3 marks**

ii. The marginal cost of capital (retained earnings, debt and preferred stock). **5 marks**

QUESTION THREE (12marks)

Snowman Manufacturers Ltd is contemplating investing in a machine for its manufacturing processes. The machine will be used to manufacture a product known as "snowman". The machine will cost sh.5 million and will incur installation costs amounting to sh.500,000. The machine is expected to have an economic useful life of 5 years and a resale value of sh. 1 million at the end of this period.

The acquisition of this machine is expected to cause changes in working capital at the beginning of the expectedlife of the machine. Inventories balances are expected to increase by sh.2 million, accounts receivable will increase by sh. 2.5 million, accounts payable will increase by sh.1.5 million. The net change in working will be recovered at the end of the machine's economic life.

The estimated Earnings before depreciation and tax from year one to year five are sh. 1,110,000, sh. 820,000, sh 468,000, sh 777,760, sh 1,139,792 respectively.

Additional information:

a. The company applies the straight line method of depreciation for all its fixed assets.
b. The company's cost of capital is 12%
c. Corporation tax rate is 30%.

Required:

i. The effective initial outlay**5 marks**
ii. The net cash flow for each year**4 marks**
iii. Using the net present value technique, advise the company on whether the machine should be purchased. **3 marks**

QUESTION FOUR (15marks)

a. Discuss five differences that exists between money market and capital market. **5 marks**
b. The current credit terms of Mascot Ltd are 2/15-net 45 days. The company's total annual sales are sh.200 million with averagecollection period of 30 days. Variable cost is 80% of the annual sales

   50% of customers take advantage of the current discount.

   The company is considering relaxing its discount terms to 3/15-45 days. This relaxation of discount terms is expected to increase annual sales by sh.10 million, reduce average

   collection period to 27 days and increase the propotion of customers who will take advantage of this discount to 60%. The company's cost of capital is 12%.

   Corporate tax rate is 30%. Assume 360 days in a year.

   Required:

   i. Calculate the annual after tax profit for current policy and proposed terms. **6 marks**
   ii. Based on (i) above, advise the management on whether the discount terms should be relaxed. **1 mark**

c. An investor has two securities, X and Y, with the following characteristics:

State of the economy	Probability	Returns	
		X (%)	Y(%)
Recession	0.3	12	6
Stable	0.4	15	7.5
Expansion	0.3	10	5

Required:Determine:

i.	The expected return for each security.	**1 marks**
ii.	The standard deviation for each security.	**1 marks**
iii.	The coefficient of variation for each security.	**1 marks**