CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

THIRD YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 337: FINANCIAL MANAGEMENT 1

STREAMS: BCOM Y3S2 **TIME: 2 HOURS**

DAY/DATE: WEDNESDAY 07/8/2019 **2.30 P.M. – 4.30 P.M**

INSTRUCTIONS: Answer question ONE and any other THREE

QUESTION ONE (30 MARKS)

(a) Explain WACC in relation to a firm's capital structure. [3 marks]

(b) The following information was extracted from the books of Colo ltd.

Ordinary shares (sh. 20 par)	1,000,000
8% preference shares (sh. 10 par)	800,000
10% debentures (sh. 20 par)	600,000
	2,400,000

The market value of the finances was as follows

Ordinary share sh. 26 (included sh. 2 floatation cost)

8% preference shares sh. 8 each

10% debentures sh 25

Ordinary shares expect a cash dividend of sh. 4 per share and capital appreciation of sh. 1 at the end of year

Required:

(i) Cost of capital for each finance [6 marks]

(ii) Weighted Average Cost of Capital [6 marks]

(c) Dobe ltd, a manufacturing company in Kenya has laid down various financial strategies to increase its market share from the current 26% to 45% in the next 5 years. The management has consulted you as a financial expert on a number of issues

(i) Explain to them three agency relationships that may hinder them achieve their objective. [6 marks]

(ii) Explain three financial strategies the management may consider appropriate to achieve their target [6 marks]

(d) Explain the difference between profit maximization and wealth maximization as used in finance management [3 marks]

QUESTION TWO (20 MARKS)

A company is considering replacing old machinery that has been used in production for a number of years. The relevant facts regarding the two assets are as follows:

	Old asset	**Proposed asset**
Cost	8M	10.8M
Salvage	0.5M	0.8M
Current market value	2.8M	10.8

Expected PBIT

Years	1-3	1.5M	3.0M
	4-6	1.0M	2.5M

The total useful life of old asset is 10 years and 6 years respectively. The old asset is 4 years old. The company depreciates its non-current assets using the straight line method. Corporate tax rate is 30%.

Required rate of return is 12%. Assume that depreciation is allowed for tax purposes and that capital gains (losses) are taxable (tax allowable)

Required:

Advice the management whether the old asset should be replaced with the new one. [20 marks]

QUESTION 3 (20 MARKS)

Njoroge an investor intends to invest in the securities exchange with capital from his pension. He consults you for advice concerning the intended investment. As a financial experts:

(a) Explain to Njoroge the concept of CAPM and its goal [6 marks]

(b) There are several assumptions behind the CAPM formula that have been shown not to hold in reality. Explain to Njoroge the problems with the CAPM? [8 marks]

(c) Explain the assumptions of arbitrage pricing theory. [6 marks]

QUESTION 4 (20 MARKS)

(a) Shisha ltd trades on the Nairobi Securities exchange with a rate of return of 9 percent and a beta of 1.2. The risk free rate based on the three month T-bill is 4.5 percent. Calculate the cost of the company's equity financing using CAPM. [4 marks]

(b) Outline the key differences between Operating Leverage and Financing Leverage. [8 marks]

(c) Ndonje investments intend to invest in a project with a cost of sh. 800,000. The cash flow and associated certainty equivalent coefficient (α) is as follows:

Year	Cash inflow	Certainty equivalent coefficient (α)
1	3000	0.8
2	4000	0.9
3	2000	0.5
4	1400	0.2
5	2500	0.3

Assuming a market risk of 15% and a risk free rate of 10%, determine NPV of the project using:

(i) Certainty equivalent method [4 marks]

(ii) Risk adjusted discount rate [4 marks]
