CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

POSTGRADUATE EXAMINATION FOR THE AWARD OF MASTERS DEGREE IN BUSINESS ADMINISTRATION

MBAD 835: INTERNATIONAL FINANCE

STREAMS: MBA Y2S1 **TIME: 3 HOURS**

DAY/DATE: THURSDAY 7/12/2017 **2.30 P.M - 5.30 P.M.**

INSTRUCTIONS:

- **Attempt ALL Questions.**
- **Do not write on the question paper**

QUESTION ONE

(a) Briefly explain any four factors that influence the Bid-ask spread on currency quotations. [4 Marks]

(b) Explain the attractions of countertrading in foreign trade payment. [3 Marks]

(c) A current spot and forward exchange rates for sterling are as follows:

	A$/£
Spot	2.060-2.065
3 months forward	4-3 cents

Required:

Outright forward quotation. [3 Marks]

(d) SMS PLC owes an American supplier $500,000 payable in three months' time on 31st December, 2017.

Current spot rate	$/£ 1.4821 – 1.4896
December Spot rate forecast	$/£ 1.4791 – 1.4812
Future prices: $/£(£62,500 contracts)	
Current futures price	1.4800
December futures price	1.4840

Required:
The outcome of using a futures hedge. [5 Marks]

(e) Assume the following information:

Amount to invest	$1,000,000
Current spot rate of DM	$2/DM
90 days forward rate of DM	$2.1/DM
90 days interest rate in the USA	2%
90 days interest rate in country X (DM currency)	4%

Required:
What is the rate of return for investing in country X? [5 Marks]

QUESTION TWO

(a) Explain how a company could manage foreign currency risks when invoicing a customer in a country which has no developed capital markets and currency markets. [4 Marks]

(b) Fair Ltd, a UK-based company, imports computer components from the Far East. The trading currency is the Singapore dollar (S$) and the value of the deal is S$28 million. Three months credit is given. The current spot exchange rate is S$2.8 to one Sterling Pound (£). Because of the recent volatility in the foreign exchange markets, Fair Ltd directors are worried that a rise in the value of the S$ could wipe out the profits on the deal and an option hedging method has been suggested.

The company's finance treasurer indicate that a three month call option to buy S$28 million at an exercise rate of S$2.785 could be purchased at a premium of £200,000 on the London OTC option market.

Required:
Evaluate the option hedge if the following spot rates were applicable in three month's time:

(i) S$2.78: 1£
(ii) S$2.82: 1£ [6 Marks]

(c) Write short notes on:

(i) International Money Market [3 Marks]
(ii) Correspondent Bank [3 Marks]

(d) Suppose that the Pound Sterling is bidding at $1.9724 in New York and the Euro at $1.3450 in Frankfurt. At the same time, London banks are offering the Pound Sterling at €1.4655.

Required:
Show the steps that an astute trader would follow to earn riskless profit assuming that the trader has £1,000,000. [4 Marks]

QUESTION THREE

(a) Distinguish between bilateral netting system and multilateral netting system in multinational cash management. [4 Marks]

(b) Faida Ltd came across an investment in Germany. The project costs DM10 million and is expected to produce cash flows of DM4 million in year 1 and DM3 million in each of years 2 and 3. The current spot-exchange rate is \$0.5/DM1 and the current risk-free rate in the United States is 11.3 percent, compared to that in Germany of 6 percent. The appropriate discount rate for the project is estimated to be 15 percent, the U.S. cost of capital for the company. In addition, the subsidiary can be sold at the end of three years for an estimated DM2.1 million.

Required:

Advise whether the project should be undertaken. [8 Marks]

(c) Rock Ltd is a company based in Nairobi, Kenya which does business with companies based in Tanzania. From such trade, Rock Ltd expects the following cash flows in the next six months, in the currencies specified.

Payment due in 3 months:	Kshs.116,000
Receipts due in 3 months:	Tshs.1,970,000
Payment due in 6 months:	Kshs.4,470,000
Receipts due in 6 months:	Tshs.1,540,000

The exchange rates in the Nairobi market are as follows:

	Tshs/Kshs.
Spot	17.106 - 17.140
Three months forward	0.82 - 0.77 cents
Six months forward	1.39 – 1.34 cents

	Interest Rates	
	Borrowing	Lending
KShs.	12.5%	9.5%
Tshs.	9.0%	6.0%

Required:

The net Kenya shillings receipts/payments that Rock Ltd might expect for its **six months** transaction if the company hedges foreign exchange risk on the:

(a) Forward Foreign exchange market [4 Marks]

(b) Money market [4 Marks]

QUESTION FOUR

(a) The following information was obtained from the financial markets in Kenya and in the Unites States of America (USA).

1. The spot rate between 1US$=Kshs.100
2. The forward premium on the US$ is 6.8% per annum
3. The investment rate in Kenya is 18.8% per annum
4. The borrowing rate in the USA is 10.2% per annum

An investor intends to borrow US$ 10,000 in the USA and invest the amount in Kenya.

Required:

Advise if arbitrage opportunity exists and the expected arbitrage profits (if any). [6 Marks]

(b) Explain how currency swaps could be used to hedge against the foreign exchange operating exposure of a firm. [3 Marks]

(c) The central international financial question concerning the pricing of assets, and hence their expected rates of return, is whether they are determined in an integrated of segmented markets.

Required:

Distinguish between integrated markets and segmented markets. [3 Marks]

(d) The HP Group is a multinational group of companies with head quarters in the US. The treasury manager at group's head office intends to introduce a system of netting to settle balance owed within the group instead of between the two affiliates every end of the year. The inter-affiliate transfer of funds cost one percent of the transaction amount. The predicted balances owing to, and owed by, the group companies at the end of year are as follows:

Owed by:	**Owed to:**	**Local currency (million)**
USA	South Africa	US $ 12.17
South Africa	Europe	SA R42.65
Denmark	USA	D Kr21.29
Europe	USA	US $19.78
USA	Europe	€1.57
South Africa	Denmark	D Kr16.35
Denmark	Europe	€1.55
South Africa	Denmark	D Krl6.35
Denmark	Europe	€1.55

The exchange rate, used in the calculations of the balances to be settled, is as follows:

	DKr	**US$**	**SA R**	**€**
1 D Kr =	1.0000	0.1823	1.9554	0.1341
1 US $ =	5.4855	1.0000	10.7296	0.7358
1 SA R =	0.5114	0.0932	1.0000	0.0686
1 € =	7.4571	1.3591	14.5773	1.0000

Required:

The cost saving as a result of the group adopting a multi-lateral netting system. [8 Marks]

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