CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

SECOND YEAR EXAMINATION FOR THE AWARD OF DEGREE OF MASTER OF BUSINESS ADMINISTRATION

MBAD 832: ADVANCED FINANCIAL MANAGEMENT

STREAMS: MBAD Y2S1 **TIME: 3 HOURS**

DAY/DATE: MONDAY 03/12/2018 **2.30 PM – 5.30 PM**

INSTRUCTIONS:

Answer ALL Questions
Do not write on the question paper

QUESTION ONE

(a) Explain any four implications of efficient market hypothesis to financial decision making. [8 marks]

(b) Researchers at Annex Electrical Ltd have invented a new television model. The company is ready to pilot production and test marketing within six months at a cost of ksh. 40 million. It is expected that there is a 70% chance of pilot production and test marketing being successful. In case of success, Annex Electrical ltd can build a plant at a cost of ksh. 300 million

The plant will generate an annual cashflow of ksh. 60 million for 20 years if demand is high or an annual cashflow of ksh. 40 million if demand is low. A high demand has a probability of 0.6. The company's required rate of return is 12%.

Required:

Advice the management of Annex Electrical ltd on the best course of action. [8 marks]

(c) Assume two assets i and j. Asset i has a probability of 40% of generating a return of USD10 and 60% of generating a return of USD2.

Asset j has a probability of 30% of generating a return of USD 9 and 70% of generating a return of USD 4. If utility of wealth is In(W), which asset will you prefer. [4 marks]

(d) Explain any five determinants of working capital needs of a firm. [5 marks]

QUESTION TWO

(a) Mr. Njeru's investment portfolio comprises of 490 shares in company ABC ltd and ksh. 20,000 depostied in his savings account. ABC Ltd has declared a rights issue of one share for every five shares held at an issue price of sh. 20 per share. The current market price per share of ABC ltd is ksh. 35. Mr. Njeru would obtain the funds required to exercise the rights form the savings account. Similarly, proceeds from sale of the rights would be desisted (credited) to his savings account.

Required:

(i) Calculate the value of each right [4 marks]

(ii) Analyse the effect of right issue on the value of Mr. Njeru's investment portfolio and hence advice him on whether to exercise, sell or ignore rights issue. [6 marks]

(b) XYZ Company Ltd is interested in acquiring the use of an asset costing ksh. 500,000. It has two options:

(I) To borrow the amount at 18% interest per annum repayable in 5 year end instalment, and use the amount to buy the asset or

(II) To take the asset on lease for a period of 5 years at the year end lease rentals of ksh 120,000

The corporate tax is 50% and depreciation is allowed on written down value of the asset at a rate of 20%. The asset will have a salvage value of ksh. 180,000 at the end of 5 years.

Required:

Advice the company on whether to buy or lease the asset. [12 marks]

(c) Differentiate between Escalator lease and step-up lease. [3 marks]

QUESTION THREE

(a) ABC ltd wants to diversify into fertilizer business and organize as a new division. The company formed a comparable fertilizer company of roughly the same characteristics as the proposed division. It has an equity beta of 1.35 and a debt ratio of 0.72. The corporate tax rate is 35%. ABC ltd will have a debt ratio of 0.5 for the proposed fertilizer business. The risk free rate is 8% and the market risk premium is 10%.

Required:

Calculate the cost of equity for the proposed new division. [6 marks]

(b) Explain the following defensive targets applied by a target firm during a take over bid

(i) Golden parachutes [2 marks]
(ii) Poison pills [2 marks]
(iii) Getting a white knight [2 marks]

(c) You have been provided with the following data for two companies

T Ltd	A Ltd
EAT (sh.) 700,000	1,000,000
No. of equity shares 200,000	400,000
EPS 3.50	2.50
P/E Ratio 10	14
Market price per sha (sh.) 35	35

A ltd is to acquire T ltd. The exchange ratio is based on the market prices of the shares of the companies

Required: Determine

(i) The exchange ratio [1 mark]
(ii) Post merger EPS [2 marks]
(iii) Change in EPS of A ltd and T ltd after merger [2 marks]
(iv) Combined P/E ratio [2 marks]
(v) Post merger market value [3 marks]

(d) Differentiate between allocative efficiency and operational efficiency. [3 marks]

QUESTION FOUR

(a) Consider two firms which are similar in all respect except for their capital structures. Firm L has a debt of ksh. 4 million of 7.5% debt while firm U is an all equity financed company. Both firms have an EBIT of ksh. 900,000. The equity capitalization rate (Ke) is 10% and the corporate tax rate is 40%.

Required:

(i) Calculate the value of the two firms using Net Income Approach [4 marks]

(ii) Using MM's Model, calculate the equilibrium value of the levered firm (L) [2 marks]

(iii) Show how an investor owning 10% of the shares of overvalued company can increase his returns without increasing risk. [5 marks]

(b) Huruma ltd sells merchandize on credit terms of Net 50 while the industrial average is Net 30. The company makes average sales of kshs. 3,000,000 per annum. The average number of days sales in accounts receivable is 60 days.

- The company is considering changing its credit terms to net 30 on all sales. The change of credit is expected to result in the following:
- Sales would reduce to ksh. 2.6 million p.a

Accounts receivable would drop to 35 days of sales

Additional information

1. The variable cost ratio is 70%
2. The corporation tax is 30%
3. Interest on funds invested in accounts receivable is at a rate of 11% per annum
4. Assume a year has 360 days

Required:

Assess whether the company should change its credit terms to net 30. [8 marks]

(c) Explain any four methods of incorporating Risk in Capital Budgeting. [6 marks]
