CHUKA  **UNIVERSITY**

UNIVERSITY EXAMINATIONS

EXAMINATION FOR THE AWARD OF DEGREE OF MASTER OF PROCUREMENT AND LOGISTICS MANAGEMENT AND MASTER OF HOTEL MANAGEMENT

MBAD 831: FINANCIAL MANAGEMENT

STREAMS: MBAD Y1S2 **TIME: 3 HOURS**

DAY/DATE: WEDNESDAY 19/4/2023 **2.30 P.M. – 5.30 P.M.**

INSTRUCTIONS: Answer Question One and any other Three

QUESTION ONE

a) Outline four limitations of the Capital Asset Pricing Model (CAPM) as an investment appraisal technique. (4 marks)

b) A piece of equipment requiring the investment of 2.2 million is being considered by Brookers Ltd. The equipment has a ten-year useful life and an expected salvage value of sh 200,000. The company uses the straight-line method of depreciation for analyzing investment decisions and faces a tax rate of 40%.

A pessimistic forecast projects cash earnings before depreciation and taxes at sh 400,000 per year compared with an optimistic estimate of sh 500,000 per year. The probability associated with the pessimistic estimate is 0.4 and 0.6 for the optimistic forecast. The company has a policy of using a hurdle rate of 10% for replacement investments, 12% (its cost of capital) for revenue expansion investments into existing product lines and 15% projects involving new areas of new product lines.

Required:

i) Compute the expected annual cash flows associated with the proposed equipment investment. (5 marks)

ii) Would you recommend acceptance of the project if it involved expansion of sales for an existing product? (5 marks)

iii) Would it be acceptable if it was for the replacement of equipment with a book value of sh 200,000 at the end of the tenth year but which could be sold at that time for only sh 40,000? (5 marks)

iv) Discounted cash flow methods were developed for idealized settings of complete and perfect capital, factor and commodity markets. Explain what complications arise when an attempt is made to apply these methods in real life markets that are neither complete nor perfect. (6 marks)

c) A company is considering a project whose initial cost is 10,000 and useful life of 5 years. The company required rate of return is 10% and the corporate tax rate is 50%. The cash flows before depreciation and tax are as follows

Year	Ksh
1	5000
2	3000
3	2000
4	6000
5	6000

Required:

i) Calculate the payback period. (3 marks)

ii) Calculate the NPV of the project and advice the management of the company. (6 marks)

iii) Calculate the IRR of the project and advice the management of the company. (6 marks)

QUESTION TWO

a) Agency theory presents the firm as a combination of competing interest groups, two of which are shareholders and management.

Required:

Discuss how the firm's attitude to risk might vary depending on whether shareholders objectives or management oriented goals predominate in the firm's planning. (5 marks)

b) An investor has an investment fund of sh 1,000,000. He intends to apportion this fund into two securities, A and B, in the following proportion: sh 200,000 in security A and sh

800,000 in security B. The return on each security is dependent of the state of the economy as shown below:

State of economy	Probability	Return on security A	Return of security B
Boom	0.4	18%	24%
Average	0.5	14%	22%
Recession	0.1	12%	21%

Required:

i) Compute the expected returns on the portfolio. (5 marks)

ii) Standard deviation of each security (5 marks)

iii) Correlation coefficient between security A and security B (5 marks)

QUESTION THREE

a) State any four limitations of Financial Ratios (4 marks)

b) Company A and B are in the same risk class and are identical in every respect except that company A is geared while B is not. Company A has sh 6 million in 5% bonds outstanding. Both companies earn 10% before interest and taxes on their sh 10 million total assets. Assume perfect capital markets, rational investors, a tax rate of 60% and a capitalization rate of 10% for an all equity company.

Required:

i) Compute the value of firm A and B using the

1. Net Income (NI) approach and (4 marks)
2. Net Operating Income (NOI) approach (4 marks)

ii) Using the Net Operating Income (NOI) approach, calculate the after tax weighted average cost of capital for firm A and B. (5 marks)

iii) Which of the firms (A and B) has an optimal capital structure according to NOI approach and why? (3 marks)

QUESTION FOUR

a) State four dividend policies that are followed by a firm. (4 marks)

b) Companies U and L are identical in every respect except that U is unlevered while L has sh 10 million of 5% bonds outstanding. Assume:

1. That all of the Modigliani-Miller (MM) assumptions are met.
2. That there are no corporate or personal taxes.
3. That EBIT is sh 2 million
4. That the cost of equity to company U is 10%.

Required:

i) Determine the value MM estimate for each firm. (4 marks)

ii) Determine the cost of equity for both firms. (3 marks)

iii) Calculate the overall cost of capital for both firms. (3 marks)

c) Explain the managerial functions of Finance. (6 marks)

QUESTION FIVE

a) State three techniques of Financial Forecasting. (3 marks)

b) 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. (3 marks)

c) Fedha Ltd has the following capital structure as at 31st December 2020

	Sh '000'
Ordinary share capital (sh 20 per value)	10,000
Retained earnings	12,000
12% preference share capital (sh 10 per value)	4,800
10% debentures (sh 1,000 per value)	7,200

Additional information:

1. The current market price per ordinary share, preference share and debenture is sh 50, sh 24 and sh 1,200 respectively.
2. For the year ended 31st December 2020, the company paid an ordinary dividend of sh 6.00 per share. Analysts estimate that the company's earnings and dividends will grow at an annual rate of 15% indefinitely.
3. The corporate tax rate is 30%

Required:

Compute the company's weighted Average cost of capital. (10 marks)

d) State four short-term sources of finance for a firm. (4 marks)

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