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**University Examinations 2014/2015**

FIRST YEAR SECOND SEMESTER EXAMINATION FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

**BFD 5176: FINANCIAL MANAGEMENT**

**DATE: AUGUST 2015 TIME: 3HOURS**

**INSTRUCTIONS:** *Answer question* ***one*** *and any other* ***three*** *questions*

**QUESTION ONE (15 MARKS)**

1. “The finance manager spends most of his time making managerial finance decisions as opposed to routine functions”. Discuss (4 Marks)
2. In relation to the financing of a firm, differentiate the following terms:
3. Financial structure from capital structure (2 Marks)
4. Business risk from financial risk (2 Marks)
5. Watetu limited wishes to expand its output by purchasing a new machine worth Kshs.170,000 and installation costs are estimated to Kshs.40,000. In the 4th year, this machine will call for an overhaul to cost Kshs.80,000. Its expected inflows are:

Year 1 2 3 4 5 6

Cash flows 60,000 72,650 35,720 48,510 91,630 83,715

This company can raise finance to purchase machine at 12% interest rate

Compute NPV and PI and advise management accordingly (4 Marks)

1. Discuss the factors that influence the dividend decisions (3 Marks)

**QUESTION TWO (15 MARKS)**

1. Exactly 20 years from now, Gicagua a former forest guard will start receiving a pension of shs.100,000 per year. the payments will continue for 20 years. How much is the pension worth now assuming a cost of capital of 12% (3 Marks)
2. ManBro Ltd wishes to make a choice between two mutually exclusive projects. Each of these projects requires shs.400,000,000 in initial cash outlay. The details of the two projects are as follows:

**PROJECT A**

This project is made up of two sub-projects. The first sub-project will require an initial outlay of shs.100,000,000 and will generate shs.25,600,000 per annum in perpetuity. The second sub-project will require an initial outlay of shs.300,000,000 and will generate shs.85,200,000 per annum for the 8 years. Both sub-projects are to commence immediately.

**PROJECT B**

This project will generate shs.87,000,000 per annum in perpetuity. The company has a cost of capital of 16%.

**Required**:

1. Determine the net present value (NPV) of each project (4 Marks)
2. Compute the internal rate of return (IRR) for each project (5 Marks)
3. Advise Magma Ltd on which project to invest in and justify your choice (3 Marks)

**QUESTION THREE (15 MARKS)**

1. Muthigi Company Ltd requires 20,000 units of a component in its manufacturing process in the coming year which costs shs.500 each. The items are available locally and the leadtime in one week. Each order costs shs.500 to prepare and process while holding cost is shs.150 per unit per year for storage plus 10% opportunity cost of capital

**Required:**

1. How many units should be ordered each time an order is placed to minimize inventory costs?
2. What is the reorder level?
3. How many orders will be placed per year?
4. Determine the total relevant costs (10 Marks)
5. Within a financial management context, discuss the agency problems that might exist in the relationships between:
6. Share holders and managers, and
7. Shareholders and creditors

How might a company attempt to minimize such problems? (5 Marks)

**QUESTION FOUR (15 MARKS)**

1. Kanyaru Ltd, is considering three possible capital projects for next year. Each project has a 1 year life, and project returns depend on next year’s state of the economy. The estimated rates of return are shown below

**STATE OF THE ECONOMY PROBABILITY OF RATE OF RETURN**

**OCCURRENCE A B C**

Recession 0.25 10% 9% 14%

Average 0.50 14 13 12

BOOM 0.25 16 18 10

**Required:**

1. Find each project expected rate of return, and standard deviation
2. Compute the correlation coefficient between
3. Compute the expected return on a portfolio if the firm invests equal wealth on each asset
4. Compute the standard deviation of the portfolio (10 Marks)
5. Discuss any two dividend decision theories (5 Marks)

**QUESTION FIVE (15 MARKS)**

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

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

Required:

1. Determine the value MM would estimate for each firm (4 Marks)
2. Determine the cost of equity for both firms (5 Marks)
3. What is the overall cost of capital for both firms (3 Marks)
4. Suppose the value of U is shs.20 million and that of L is shs.22 million. Explain the arbitrage process for a shareholder who owns 10% of company L’s shares (3 Marks)