UNIVERSITY OF EMBU

2017/2018 ACADEMIC YEAR

TRIMESTER EXAMINATIONS

FIRST YEAR TRIMESTER EXAMINATION FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

DFI 501: FINANCIAL MANAGEMENT

DATE: AUGUST 1, 2018 **TIME: 4:00-7:00PM**

INSTRUCTIONS:

Answer ANY FOUR Questions

QUESTION ONE (25 MARKS)

a) Although profit maximization has long been considered as the main goal of a firm, shareholder wealth maximization is gaining acceptance amongst most companies as the key goal of a firm. Explain any three limitations of the goal of profit maximization in contrast to shareholder wealth maximization. (3 marks)

b) Briefly explain the term weighted average cost of capital. (3 marks)

c) The following is the capital structure of Ridges Company Ltd. as at 31 December, 2017.

	Sh. (Million)
Ordinary share capital Sh. 10 par value	400
Retained earnings	200
10% preference share capital Sh. 20 par value	100
12% debenture Sh. 100 par value	200
	900

Additional information;

1. Corporate tax rate is 30%

2. Preference shares were issued 10years ago and are still selling at par value (market price per share (MPS) = Par value)
3. The debenture has a 10 year maturity period. It is currently trading at Sh. 90 in the market.
4. Currently Ridges Company Ltd. has been paying dividend per share (DPS) of Sh. 5. The DPS is expected to grow at 5% p.a. in future. The current MPS is Sh. 40.

Required;

(i) Compute the cost of each capital component of Ridges Company Ltd. (8 marks)

(ii) Determine the market value of each capital component of Ridges Company Ltd. (6 marks)

(iii)Determine the weighted average cost of capital (WACC) of Ridges Company Ltd. (5 marks)

QUESTION TWO (25 MARKS)

a) The new little known firm is analyzed from the prospect of investments in its shares by two friends. The firm paid dividends last year of 3 shillings per share. Tomas and Arnas examined the prices of similar stocks in the market and found that they provide 12 % expected return. The forecast of Tomas is as follows: 4 % of growth in dividends indefinitely. The forecast of Arnas is as follows: 10% of growth in dividends for the next two years, after which the growth rate is expected to decline to 3 % for the indefinite period.

i) Determine the value of the share of the firm according to Tomas forecast. (4 marks)

ii) Determine the value of the share of the firm according to Arnas forecast. (6 marks)

iii) If the stocks of this firm currently are selling in the market for 40 shillings per share, identify and explain the most appropriate decisions of Tomas and Arnas, based on their forecasting. (3 marks)

b) Mali Nyingi, a Kenyan investor bought the following combination of shares at the indicated prices in January 2018:

Share	No. of shares	Unit price
SCB	20,000	Sh.165
Bamburi Cement	50,000	Sh.150
Nation Media Group	30,000	Sh.72

At the end of the year, the prices had risen to Sh.231; Sh.196 and Sh.115 for SCB, Bamburi and Nation Media Group respectively. None of the shares paid dividend during the year.

Required:

Compute the portfolio value weighted mean rate of return. (6 marks)

c) On January 1, 2011, Dawanu Ltd. issued Sh. 100, 000 of eight-year bonds with a year-end interest (coupon) payment of 8% per annum. Determine the value of this bond on January 1, year 2016, when the yield to maturity on these bonds wass 6% per annum. (6 marks)

QUESTION THREE (25 MARKS)

a) Briefly explain the importance of the following ratios to an investor.

i) Earnings per share. (2 marks)

ii) Divided yield. (2 marks)

b) Explain any three limitations of the use of ratios as a basis of financial analysis. (3 marks)

c) Discuss the agency relationship between the owners and the management in the context of a public limited company. (3 marks)

d) Consider the following cash flows of two mutually exclusive projects for Mapengocaster Rubber PLC. The companies required rate of return is 10%.

Year	Project A	Project B
0	(800,000)	(600,000)
1	500,000	400,000
2	300,000	600,000
3	900,000	200,000

Required;

Evaluate which project should be taken on the basis of the following techniques.

i) Payback period (2 marks)

ii) Net present value (4 marks)

iii) Internal rate of return (5 marks)

iv) Profitability index (4 marks)

QUESTION FOUR (25 MARKS)

a) Briefly explain the following dividend theories;

i) Clientele effect dividend theory (3 marks)

ii) Bird-in-the-hand dividend theory (2 marks)

b) The managing directors of three profitable listed companies discussed their company's dividend policies at a business lunch.

- Company A has deliberately paid no dividends for the last five years.
- Company B pays dividends of 50% of earnings after taxation.
- Company C maintains a low but a constant dividend per share (after adjusting for the general prices index) and offers regular script issues and shareholders concessions.

Each managing director is convinced that his company's dividend policy is maximizing shareholders wealth.

Required:

Evaluate the alternative dividend policies of the three companies and the circumstances under which each managing director might be correct in his belief that the adopted dividend policy maximizes shareholders wealth. (10 marks)

c) Two firms, A Ltd and B Ltd. operate in the same industry. The two firms are similar in all aspects except for their capital structures. The following additional information is available:

1. A Ltd is financed using Sh.100 million worth of ordinary shares.
2. B Ltd is financed using Sh.50 million in ordinary shares and Sh.50 million in 7% debentures
3. The annual earnings before interest and tax are Sh.10million for both firms. These earnings are expected to remain constant indefinitely.
4. The cost of equity in A Ltd is 10%
5. The corporate tax rate is 30%

Required:

Using the Modigliani and Miller (MM) model, determine the following:

i) The market value of A Ltd. and B Ltd. (4 marks)

ii) The weighted average cost of capital of A Ltd and B Ltd. (6 marks)

QUESTION FIVE (25 MARKS)

a) The working capital policy of any business entity addresses the twin issues of the level of current assets and the manner in which the current assets are financed. Explore any three (3) approaches to financing current assets. (6 marks)

b) Jabali Limited maintains a minimum cash balance of sh. 500,000. The deviation of the company's daily cash changes is sh. 200,000. The annual interest rate is 14%. The transaction cost of buying or selling securities is sh. 150 per transaction.

Required:

Using the Miller- Orr cash management model, determine the following;

i) Target cash balance (4 marks)

ii) Upper cash limit (2 marks)

c) Ujuzi Limited wishes to raise Sh. 1 Billion for the expansion of their plant in the next one year. Discuss three reasons why it should raise this fund through issue of ordinary shares and not an issue of a bond. (6 marks)

d) Madam Mrembo has a capital of Ksh.1,000,000 which she wishes to invest in two sectors. A and B as follows; Ksh.200,000 in security A and Ksh.800,000 in security B. The return on each security is dependent on the state of the economy as shown below.

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

Required:

Determine;

(i) Expected returns on the portfolio (3 marks)

(ii) Risk of the portfolio in standard deviation (4 marks)

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