The Co-operative University of Kenya

END OF SEMESTER EXAMINATIONS DECEMBER-2019

EXAMINATION FOR THE DEGREE OF BACHELOR OF SCIENCE IN FINANCE
(YR IV SEM II)

UNIT CODE: CMFI 2204

UNIT TITLE:FINANCIAL MANAGEMENT II

DATE: 9th DECEMBER 2019 **TIME: 9:00 AM – 11:00 AM**

INSTRUCTIONS:
- Answer question **ONE (compulsory)** and any other **TWO** questions

QUESTION ONE

(a) Discuss the arguments for mergers and acquisitions (6 marks)

(b) An investor has two securities, Y and Z, with the following return characteristics:

State of Economy	*Probability*	*Returns Security Y (%)*	*Returns Security Z (%)*
Recession	0.3	12	6
Stable	0.4	15	7.5
Boom	0.3	10	5

Required:
Assess the riskiness of securities Y and Z (6 marks)

(c) Explain the factors affecting multinational capital budgeting. (6 marks)

(d) An investor holds 500 shares in SGL Ltd, a quoted company. SGL Ltd has been paying average dividends of Sh.2 per share per annum in recent years. The dividends are expected to grow at a rate of 15 percent per annum over the coming three years, then at a rate of 10 percent over the next three years and finally at a rate of 5 percent per annum to perpetuity. The required rate of return is 9 percent.
Required:
The value of the 500 shares in SGL Ltd, using the dividend growth model (7 marks).

(e) A project under consideration has the following projected cash flows which are in current terms.

Time	*T_0*	*T_1*	*T_2*	*T_3 - T_{10}*
Cash flows Ksh'000'	(1,700)	100	200	300

The rate of inflation which will affect all cash flows equally is 3% and the firms required money return is 10%
Required:
Calculate the NPV of the project and determine whether the project is acceptable. (5 marks)

QUESTION TWO

(a) Highlight the limitations of the following methods of dealing with risk in capital budgeting;

i) Simulation analysis (3 marks)

ii) Sensitivity analysis (3 marks)

(b) Viking limited is evaluating a new technology for its reproduction equipment. The technology will have three- year life and would cost Sh.800,000. Its impact on the company's cashflows is subject to risk. In the first year, management estimates that there is an equal chance that technology will either succeed and save the company Sh.800,000 or fail saving it nothing at all. If the technology fails in the first year, savings in the last two years will be zero. Even worse, there is a 40% chance that additional Sh.240,000 may be required in the second year to convert back to the original process.If the technology succeeds in the first year, the second-year cash flows may be Sh1,440,000, sh.1,120,000 or sh.800,000 with probabilities of 0.20,0.60 or 0.20 respectively. Third year cash flows are then expected to be Sh.160,000 greater or Sh.160,000 less than cash flows in the second year with equal chance of each occurring. All cash flows are after taxes.

Required;

i) A probability tree depicting the above cash flow possibilities. (5 marks)

ii) Net present values for each possibility using a risk-free rate of 5%. (5 marks)

iii) The expected net present value of the technology using a risk-free rate of 5%. (4 marks)

QUESTION THREE

The following is the earnings per share (EPS) record of Biashara Limited over the past 10 years

Year	*EPS*	*Year*	*EPS*
1	1	2	(2)
3	9	4	6
5	12	6	16
7	15	8	16
9	19	10	20

Required:

Determine the annual dividend in the following cases:

(a) If the firms dividend policy is based on a constant dividend payout ratio of 50% for all years. (5 Marks)

(b) If the firm pays dividend at Sh8 per share and increases to Sh10 per share when earnings exceeded Sh14 per share for the previous two consecutive years. (5 Marks)

(c) If the firm pays dividend at Sh7 per share each year except when EPS exceeds Sh14 per share when an extra dividend equal to 80%of earnings beyond Sh14 would be paid. (6 Marks)

(d) Which type of dividend policy will you recommend to the company and why. (4 Marks)

QUESTION FOUR

(a) Explain how 'information content' and 'clientele effect' influence a firm's dividend policy. (4 Marks)

(b) Outline the reasons that may constrain a company from paying dividends to its shareholders at the end of a financial year. (6 marks)

(c) Explain four reasons that may drive a company to raise equity finance rather than debt finance .(4 marks)

(d) Effort manufacturing limited is evaluating an investment opportunity that would require an outlay of Sh. 100 million. The annual net cash inflows are estimated to vary to economic conditions.

Economic Conditions	*Probability*	*Cashflow (Ksh Millions)*
Very good	0.10	35
Good	0.45	28
Fair	0.30	24
Poor	0.15	18

The firm's required rate of return is 14 percent. The project has an expected life of six years.

Required:

Compute the expected net present value (NPV) of the proposed investment. (6 marks)

QUESTION FIVE

(a) Outline the factors that should be considered by a company in determining its capital structure. (4 marks)

(b) The following extract of the Statement of financial position of Upendo limited shows the capital structure of the company as at 31 December 2011.

	Sh'000'
Ordinary share capital (par value) Sh.125)	62,500
Reserves	121,500
Shareholder's equity	184,000
Long-term Liability:	
14% debentures stock (par value Sh.500)	118,500
Capital employed	302,500

The management of the company considers the above capital structure to be optimal.

Additional information:

- The company's earnings before interest and tax (EBIT) average Sh.75 Million per annum. These earnings are expected to be maintained in the foreseeable future.
- The ordinary shares are currently trading at Sh.400 per share.
- The market price of the debentures is Sh.525 per debenture.
- The corporate rate of tax is 30%.

Required:

Using the net income approach (incorporating taxes), calculate the company's

i) Cost of equity. (4 marks)

ii) After tax-cost of debt (market-valueweighted). (3 marks)

iii) Market-weighted cost of capital. (3 marks)

(c) A limited and B limited are identical in all aspects except that A limited is unlevered while B limited has issued sh. 10 Million 5% corporate bond.The earnings before interest and tax (EBIT) for the two companies are sh.2million per annum and the cost of equity of A limited is 10%.

Required:

Using Modigliani and miller (MM) without taxes model, answer the following:

i) Determine the value of each company. (2 marks)

ii) Determine the cost of equity of B limited. (2 marks)

iii) Determine the weighted average cost of capital of each company. (2 marks)