MURANG'A UNIVERSITY COLLEGE

(A constituent College of Jomo Kenyatta University of Agriculture & Technology)

MAIN CAMPUS

SPECIAL/SUPPLEMENTARY UNIVERSITY EXAMINATIONS

2015/2016 ACADEMIC YEAR

THIRD YEAR FIRST SEMESTER EXAMINATIONS

FOR THE DEGREE

OF

BACHELOR OF COMMERCE

COURSE CODE: HBF 2302;

COURSE TITLE: ADVANCED FINANCIAL MANAGEMENT

DATE: ....**TIME**.......................................

INSTRUCTIONS TO CANDIDATES

Question ONE (1) is compulsory

Answer ANY other TWO (2) questions

MRUC observes ZERO tolerance to examination irregularities

This Paper Consists of 6 Printed Pages. Please Turn Over.

QUESTION ONE

a) Differentiate between;

i. Financial leverage and operating leverage (2mks)
ii. Weighted average cost of capital and marginal cost of capital. (2mks)
iii. "Maximising" and "satisficing" of shareholders wealth in a company.(2mks)
iv. Hard rationing and soft rationing. (2mks)

b) Discuss any four assumptions of Modigliani-Miller (MM-I) theory. (4mks)

c) PQR undertook project 'A' with the following cash flow over its useful life of 3 years. The cost of capital for the project is 10%. The abandonment values of the project have been given below:-

Year	cash flow Sh000'	Abandonment values sh000'
0	(9,600)	9,600
1	4,000	6,000
2	3,750	3,800
3	3,500	0

Required

Advice the management of PQR ltd, when to abandon the project A. (8mks)

d) A company is considering two mutually exclusive projects. The Company uses the certainty- equivalents approach to determine the net present values. The estimated cash flows and certainly-equivalents for each project are as follows

	Project I		**Project II**	
Year	Cash flows Sh	Certainty Equivalents	Cash flow Sh	Certainty Equivalent
0	(30,000)	1	(40,000)	1.00

1	15,000	0.95	25,000	0.900
2	15,000	0.85	20,000	0.800
3	10,000	0.70	15,000	0.70
4	10,000	0.65	10,000	0.60

Required:

Determine the project which is to be preferred, if the risk-free discount rate is 5%

[10mks]

[Total: 30 marks]

QUESTION TWO

a) Determine any **six** factors to be considered when making a capital structure decision (6mks)

b) Describe the pecking order theory as regards the capital structure of companies.(4mks)

c) ABC ltd has the following capital structure as at 31st march 2013.

Ordinary share capital [400,000sheres]	16,000,000
10% preference share capital	2,000,000
14% Bond capital	14,000,000

Additional informational:

[1] The market price of each ordinary share as at 31st March 2013 was sh40.
[2] The firm paid is divided of sh. 4 for each ordinary shares for the year ended 31 march 2013.
[3]The annual growth rate in divided is 7%.
[4] The corporation tax rate is 30%.

Required:

[i] Compare the weighted average cost of capital [WACC] of the firm as at 31st March 2013. (5marks)

[ii] The firm intends to issue 15% sh4million bond during the year ending 31st March 2015.The existing bond will not be affected by the issue. The dividend per share for the year ending 31 March 2015 will be expected to be sh. 6 while the average market price per share over the same

period is estimated to be sh.60. The average annual growth rate in dividends is expected to remain at 7%.

Required:

Compute the weighted average cost of capital as at 31st march 2015. [5marks]

[Total 20marks]

QUESTION THREE

a) Explain the importance of the following terms as they relate to dividend issues:

[i] A Bird-in-hand (2 marks)

[ii]Asymmetric Information (2 marks)

[ii)``Home made'' dividend (2 marks)

[iv]Signaling theorem (2 marks)

b)The management of XYZ ltd has ascertained that the firm will require sh.5,000,000 in cash for transactions purposes during the forthcoming financial year. The interest rate on marketable securities is presently 10% per annum and is expected to remain constant over the next financial year.The cost of converting marketable securities to cash is sh. 100 per transaction.

Required

Using the Baumol cash management model determine the following:

i. Optimal cash conversion size. (3mks)
ii. Average cash balance (3mks)
iii. How after (in days) the firm should make conversions (2mks)
iv. The total cost of managing the optimal cash balance (4mks)

(Total; 20mks)

QUESTION FOUR

A company manufacturing animal feeds in Murang'a county is considering the purchase of a new machine to replace the two machines which are currently in use. The new machine would result in reduced labour-cost because of the more automated nature of the process and in addition, would permit service levels to be increased by creating greater capacity at the various stages. It has been estimated that the new machines will lead to increased profits in each of the next three years. Due to uncertainty in demand, however, the annual cash flows (including savings) resulting from purchase of the larger new Machines cannot be fixed with certainty and have therefore been estimated probabilistically as follows:

Year	Annual cash flow Sh`M'	Probability
1	10	0.30
	15	0.40
	20	0.30
2	10	0.10
	20	0.20
	30	0.40
	40	0.30
	10	0.30
3	20	0.50
	30	0.20

After allowing for scrap value of the existing machines, the net cost of the new machines will be sh.40 million. The effects of taxation are to be ignored.

Required:

a) Based on the average annual cash flow, calculated the NPV of the new machine given that the company's cost of capital is 12%. (7mks)

b) Analyze the risk inherent in this situation by simulating the NPV calculations. On the basis of your simulation results, determine the NPV. (10mks)

c) What is the probability of the new machine yielding a negative NPV? (3mks)

NB: Use the following random numbers in answering part (b) above.

432367	762478	980745	284639
197283	584902	192039	183746
172837	264835		

(Total 20 marks)