

15  
TLC



*(KNOWLEDGE FOR DEVELOPMENT)*

**KIBABII UNIVERSITY**

**UNIVERSITY EXAMINATIONS**

**2017/2018 ACADEMIC YEAR**

**SECOND YEAR SECOND SEMESTER**

**MAIN EXAMINATION (TOWN CAMPUS)**

**FOR THE DEGREE OF BACHELOR OF COMMERCE**

**COURSE CODE: BCF 303**

**COURSE TITLE: CORPORATE FINANCE**

**DATE: 11/01/2018 TIME: 2.00 P.M – 4.00 P.M**

---

**INSTRUCTIONS TO CANDIDATES**

**ANSWER QUESTION ONE IN SECTION A AND ANY OTHER TWO (2) QUESTIONS IN SECTION B**

**TIME: 2 HOURS**

KIBUCO observes ZERO tolerance to examination cheating

This Paper Consists of 4 Printed Pages. Please Turn Over. ►

## Question one (compulsory)

- a) Discuss how manager's objectives might differ from those of shareholders in a public limited company and illustrate the policies that managers might adopt that are likely to be considered sub-optimal from the shareholders point of view (10mark)
- b) Zed limited, an all equity firm, wishes to appraise five one- year projects. Details are:

| Project | Initial expenditure(sh000) | End year cash flow (sh000) | Beta estimate |
|---------|----------------------------|----------------------------|---------------|
| V       | 1,000                      | 1,130                      | 1.00          |
| W       | 1,000                      | 1,140                      | 0.50          |
| X       | 1,000                      | 1,170                      | 1.25          |
| Y       | 2,000                      | 2,300                      | 0.75          |
| Z       | 2,000                      | 2,360                      | 1.75          |

The current equity beta of the company is 0.75. The risk free rate of interest is 6% and the expected return on the market portfolio is 14%. Acceptance of any or all of the above projects will have no measurable impact on the return or behavior of the market portfolio. Zed limited is uncertain whether its overall cost of capital should be used to appraise all the projects or whether a different discount rate should be used for each project.

Required :

Determine the net present value of each project using:

- Zed's overall cost of capital ( 5marks)
- A separate discount rate for each project derived from the capital asset pricing model utilizing the individual project betas( 5marks)
- Indicate which of the two approaches to the determination of discount rate is to be preferred and advice Zed limited which of the project is worthwhile( 4 marks)
- Outline the main practical limitations of portfolio theory (6marks)

## SECTION B (CHOOSE ANY TWO QUESTIONS)

### Question Two

- Explain reasons why cash may be validly retained within a business other than for shareholders' required return (6marks)
- XYZ limited has two types of funds: equity shares and 6% irredeemable debentures. The market values of funds are as shown:

| Fund                  | market value (000) |
|-----------------------|--------------------|
| Equity shares         | 10,000             |
| 6%irredeemable shares | <u>5,000</u>       |
|                       | <u>15,000</u>      |

The debentures are quoted at sh 80. The company earns a profit of sh 1.8 million before interest. After interest, all the surplus is distributed as dividends. The company expects to maintain stable profit into the foreseeable future but to show no growth. Ignore corporation tax.

Required :

- i) Calculate the cost of equity and the cost of debt (6marks)
- ii) Compute the weighted average cost of capital (4marks)
- iii) Compute the overall cost of capital by comparing annual profits distributable to equity and debt with total market value of funds employed (2 marks)
- iv) Suggest the reasons why weighted average cost is frequently used in appraising new capital projects (4 marks)

### Question three

- a) Discuss the possible financial advantages of a company's shares being sold to a group of company managers compared with liquidation of the company (10 marks)
- b) Five managers of Mega Ltd are discussing the possibility of management buyout of the part of the company that they work for. The buyout would require a total of sh 700,000 of which sh 525,000 would comprise purchase cost and sh 175,000 for expansion in activity and working capital. The managers believe that they could jointly provide sh 70,000 (10 marks)

### Question four

- a) Explain the methods of handling risks in capital budgeting (8 marks)
- b) Omega ltd is considering investing in a project which has three year life. The project requires an initial investment of sh 20 million. The financial director has projected the following probabilities for the indicated economic conditions:

| Year | Economic conditions | Net cash flow(000) | probability |
|------|---------------------|--------------------|-------------|
| 1    | High growth         | 10,000             | 0.2         |
|      | Moderate            | 6,000              | 0.7         |
|      | No growth           | 2,000              | 0.1         |
| 2    | High growth         | 12,000             | 0.3         |
|      | Moderate growth     | 8,000              | 0.5         |
|      | No growth           | 4,000              | 0.2         |
| 3    | High growth         | 16,000             | 0.4         |
|      | Moderate growth     | 12,000             | 0.3         |
|      | No growth           | 6,000              | 0.3         |

If the company's required rate of return is 15%, should Omega ltd invest in the project? (12 marks.)

### Question Five

- a) The main purpose of foreign exchange management is to cover the company against foreign exchange exposures by dealings on forward markets with an aim of minimizing and eliminating such exposures before they become more adverse and costly.

Required;

Suggest actions that the financial director of an international firm should take in order to reduce risks from foreign currency transactions (14 marks)

- b) Discuss the factors that may complicate financial management in multi-national firms (6 marks)