MACHAKOS UNIVERSITY COLLEGE

(A Constituent College of Kenyatta University)
University Examinations for 2015/2016 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF BUSINESS ENTREPRENEURSHIP AND MANAGEMENT SCIENCES

EXAMINATION FOR MASTER IN BUSINESS ADMINISTRATION

BAC 815: FINANCIAL MANAGEMENT

Date: SCHOOLBASED **Time:**

INSTRUCTIONS:

Attempt question one and any other two questions

QUESTION ONE

(a) Explain fully the effect of the use of debt capital on the weighted average cost of capital of a company. (6 marks)

(b) Millennium Investments Ltd. wishes to raise funds amounting to Sh.10 million to finance a project in the following manner:

Sh.6 million from debt; and

Sh.4 million from floating new ordinary shares.

The present capital structure of the company is made up as follows:

1. 600,000 fully paid ordinary shares of Sh.10 each
2. Retained earnings of Sh.4 million
3. 200,000, 10% preference shares of Sh.20 each.
4. 40,000 6% long term debentures of Sh.150 each.

The current market value of the company's ordinary shares is Sh.60 per share. The expected ordinary share dividends in a year's time is Sh.2.40 per share. The average growth rate in both dividends and earnings has been 10% over the past ten years and this growth rate is expected to be maintained in the foreseeable future.

The company's long term debentures currently change hands for Sh.100 each. The debentures will mature in 100 years. The preference shares were issued four years ago and still change hands at face value.

Required:

(i) Compute the component cost of:
- a) Ordinary share capital; (4 marks)
- b) Debt capital (4 marks)
- c) Preference share capital. (3 marks)

(ii) Compute the company's current weighted average cost of capital. (5 marks)

QUESTION TWO

In a company, an agency problem may exist between management and shareholders on one hand and the debt holders (creditors and lenders) on the other because management and shareholders, who own and control the company have the incentive to enter into transactions that may transfer wealth from debt holders to shareholders. Hence the need for agreements by debt holders in lending contracts.

Required:

(a) State and explain any four actions or transactions by management and shareholders that could be harmful to the interests of debt holders (sources of conflict). (10 marks)

(b) Write short notes on any four restrictive covenants that debt holders may use to protect their wealth from management and shareholder raids. (10 marks)

QUESTION THREE

(a) List and explain five factors that should be taken into account by a businessman in making the choice between financing by short-term and long-term sources. (10 marks)

(b) Enumerate four advantages and disadvantages of venture capitalist from the point of view of the borrower. (10 marks)

QUESTION FOUR

P. Muli was recently appointed to the post of investment manager of Masada Ltd. a quoted company. The company has raised Sh.8,000,000 through a rights issue.

P. Muli has the task of evaluating two mutually exclusive projects with unequal economic lives. Project X has 7 years and Project Y has 4 years of economic life. Both projects are expected to have zero salvage value. Their expected cash flows are as follows:

Project	**X**	**Y**
Year	**Cash flows (Sh.)**	**Cash flows (Sh.)**
1	2,000,000	4,000,000
2	2,200,000	3,000,000
3	2,080,000	4,800,000
4	2,240,000	800,000
5	2,760,000	-
6	3,200,000	-
7	3,600,000	-

The amount raised would be used to finance either of the projects. The company expects to pay a dividend per share of Sh.6.50 in one year's time. The current market price per share is Sh.50. Masada Ltd. expects the future earnings to grow by 7% per annum due to the undertaking of either of the projects. Masada Ltd. has no debt capital in its capital structure.

Required:

(a) The cost of equity of the firm. (5 marks)

(b) The net present value of each project. (7 marks)

(c) The Internal Rate of return (IRR) of the projects. (Rediscount cash flows at 24% for project X and 25% for Project Y). (8 marks)

QUESTION FIVE

(a) Outline four limitations of the use of ratios as a basis of financial analysis. (4 marks)

(b) The following information represents the financial position and financial results of AMETEX Limited for the year ended 31 December 2015.

AMETEX Limited
Trading, profit and loss account for the year ended 31 December 2015

		Sh."000"	Sh."000"
Sales – Cash			300,000
- Credit			600,000
			900,000
Less: cost of sales			
Opening stock		210,000	
Purchases		660,000	
		870,000	
Less: closing stock	(150,000)		720,000
Gross profit			180,000
Less expenses:			
Depreciation		13,100	
		15,000	

Directors’ emoluments	20,900		
General expenses	4,000		
Interest on loan			
		(53,000)	
Net profit before tax			127,000
Corporation tax at 30%		(38,100)	
Net profit after tax	4,800		88,900
Preference dividend	10,000		
Ordinary dividend			14,800
Retained profit for the year			74,100

AMETEX Limited

Balance Sheet as at 31 December 2015

	Sh.”000”	**Sh.”000”**	**Sh.”000”**
Fixed Assets			213,900
Current Assets:			
Stocks	150,000		
Debtors	35,900		
Cash	20,000	205,900	
Current Liabilities:			
Trade creditors	60,000		
Corporation tax payable	63,500		
Proposed dividend	14,800	138,300	67,600
			281,500

Financed by:

Ordinary share capital (Sh.10 par value)	100,000	
8% preference share capital	60,000	
Revenue reserves	81,500	
10% bank loan	40,000	
		281,500

Additional information:

1. The company's ordinary shares are selling at Sh.20 in the stock market.

2. The company has a constant dividend pay out of 10%.

Required:

Determine the following financial ratios:

(i) Acid test ratio. (2 marks)
(ii) Operating ratio (2 marks)
(iii) Return on total capital employed (2 marks)
(iv) Price earnings ratio. (2 marks)
(v) Interest coverage ratio (2 marks)
(vi) Total assets turnover (2 marks)

(c) Determine the working capital cycle for the company. (4 marks)