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**University Examinations 2015/2016**

FOURTH YEAR SECOND SEMESTER EXAMINATION FOR THE DEGREE OF

BACHELOR OF COMMERCE

**BFC 3332: ADVANCED FINANCIAL MANAGEMENT**

**DATE: AUGUST 2016 TIME: 2 HOURS**

**INSTRUCTIONS:** *Answer question* ***one*** *and any other* ***two***questions.

**QUESTION ONE (30 MARKS)**

1. Distinguish between Hard and Soft capital rationing (3 marks)
2. Able Ltd has capital of Shs. 1,900,000 available for investment in the forthcoming period. The directors decide to consider projects P, Q and R only. They wish to invest only in whole projects, but surplus can be invested. The following is the amount of investment required for each project and the present value inflows for each discounted at 20%.

|  |  |  |
| --- | --- | --- |
| Project | Investment required | PV of inflows at 20% |
|  | Sh.000 | Sh.000 |
| P | 800 | 1,130 |
| Q | 1,000 | 1,340 |
| R | 600 | 976 |

Required:

1. For each project compute the Net Present Value (NPV) and the profitability index (P1) (4 marks)
2. Which combination of projects will produce the highest NPV at a cost of capital of 20%? (4 marks)
3. Which combination of projects will produce the highest PI at a cost of capital of 20%? (4 marks)
4. Geta Ltd. has a sales price of Shs.92.00 per unit and a variable costs of shs.72 per unit, fixed costs are shs.250,000, no debt, and sales of 120,000 units per year. Mara Ltd has a sales price of shs.195.00 per unit and a variable cost of shs.135.00 per unit with fixed costs of shs.2,500,000 and sales of 105,000 units per year. Company Mara also has interest payments of shs.1,000,000 annually. Both companies are in the 30% tax bracket.
5. Calculate Degree of Operating Leverage (DOL), Degree of Financial Leverage (DFL), and Degree of Combined Leverage (DCL) for Geta Ltd (6 marks)
6. Calculate Degree of Operating Leverage (DOL), Degree of Financial Leverage (DFL), and Degree of Combined Leverage (DCL) for Mara Ltd. (6 marks)
7. Interpret the results (3 marks)

**QUESTION TWO (20 MARKS)**

1. Describe four factors that influence the Dividend policy practice of any firm (8 marks)
2. Assume that the following data and conditions hold for firm P.
* The firm currently has no debt.
* Expected EBIT is Shs.2,400.00 which remains constant over time
* The firm pays out all its income as dividends.
* If the firm desires to borrow it can do so at 8% the borrowing rate is constant and does not change with the changes in the amount of debt, any amount raised through debt will be used to repurchase ordinary shares.
* The business risk inherent in the firm’s assets and its EBIT is such that the beta is 0.8 (unlevered beta). The firm has no debt therefore the risk free rate is 8% and the market risk premium is 5%

**Required:**

1. Using CAPMdetermine the firms required rate of return (4 marks)
2. Using MM proposition 1 without taxes determine the value of firm P. (4 marks)
3. Calculate the cost of equity and the WACC assuming that the firm borrows shs.10million debt (4 marks)

**QUESTION THREE (20 MARKS)**

1. What is Agency cost? (2 marks)
2. How do shareholders influence the behavior of managers to motivate them pursue value enhancing activities in the firm (8 marks)
3. Under MM proposition II without taxes, a company with a cost of capital of 18%, a cost of debt of 12% and a debt equity ratio of 1.5. What would be its cost of equity? (4 marks)
4. You are an investor interested in investing in Nairobi Securities Exchange with an initial investment capital of Shs.250,000. You decide to invest shs180,000 in Britam shares whose expected return is 18% with a standard deviation of 22% and shs.70,000 in Safaricom shares whose expected returns is 15% with a standard deviation of 16%. The correlation coefficient between the two securities is 0.75.

**Required:**

Calculate the expected return of the portfolio, the portfolio standard deviation and the expected total value of the portfolio after one year. (6 marks)

**QUESTION FOUR (20 MARKS)**

1. The success of any business organization is dependent on the decisions that finance managers make, using specific examples of decisions that finance managers make, describe the managerial functions of finance. (9 marks)
2. Meru Food Processors is currently involved in a restructuring progremme that involves increasing its existing debt from shs.5 million to shs.25 million. The interest rate on debt is 12% and it’s not expected to change. The company has currently one million shares outstanding and the price per share is shs.40. If the restructuring is expected to increase the Return of Equity (ROE).

What is the minimum level of EBIT that Meru Food Processors should be expecting? Ignore taxes (5 marks)

1. Describe three main sources of long term debt financing for a business firm. (6 marks)

**QUESTION FIVE (20 MARKS)**

1. Saso Ltd faces an interest rate of 18% per annum and its brokers commission Sh.70 for each transaction in the money market. The company Chief Finance Officer has stated that the minimum cash balance that is acceptable is Sh.22,000 and that the variance of cash flows on a daily basis in Sh.
2. What is the maximum level of cash the firm should hold, and at what point should it start to purchase or sell securities? (8 marks)
3. What assumptions would you make in your calculations (4 marks)
4. Explain the following financial management terms
5. Venture Capital (2 marks)
6. Financial risk (2 marks)
7. Financial leverage (2 marks)
8. Financial Markets (2 marks)