AFRICA UNIVERSITY
(A United Methodist-Related Institution)

FACULTY OF MANAGEMENT AND ADMINISTRATION

COURSE TITLE: MFN 501, FINACIAL MANAGEMENT

SEMESTER 1: FINAL EXAMINATION-NOVEMBER/ DECEMBER 2013

LECTURER: MS CHIRIMA

TIME: 3 HOURS

INSTRUCTIONS

Answer all questions in Section A; Three questions in Section B

The marks allocated to each question are shown at the end of the question.

Credit will be awarded for logical, systematic and neat presentations. Show all working.

SECTION A

Instructions

SECTION A – Answer all questions in this section. Total Possible marks = 40 marks.

Question 1 (Total Possible Marks = 20 Marks)

A. Differentiate between a rights issue, a share split issue and a bonus issue.

3 marks

B. Baobab Holdings has an outstanding share capital of $5 million in shares of $100 each. They are currently trading at $204 each. It also has 9% bonds with a par value of $2, 4 million. The company made an operating income of $072 000 in the year just ended.

   i. Determine the current level of equity gearing and the interest cover for the company.

5 marks

   ii. The company is to raise $2, 4 million to finance a new project. This will be made through a rights issue of shares at a price of $153, 60 per share. Determine and interpret the ex – right price.

6 marks

C. Assume the $2, 4 million was raised by way of a 15% loan repayable in 5 equal installments. Determine (to the nearest thousand) the annual installments repayable and prepare an amortization schedule for the loan.

6 marks

Question 2 (Total Possible Marks = 20 marks)

a) What is the present value today of a perpetuity that pays$400 per year if the first payment does not begin until four years hence and if 10% is the relevant discount rate? ***3 marks***

b) A dictionary defines risk as “the chance of bad consequences”, and uncertainty as “not to be depended on”.

   a. Discuss these terms in the context of financial management. ***3 marks***

   b. Identify the relationship between estimated risk and expected return, with respect to a financial investment. ***4 marks***

   c. Explain why an investment in a government security maybe considered to be a riskless investment ***4 marks***

c) How does the risk an investor faces in an investment of a single financial asset differ from the risk he faces in an investment of a portfolio of financial assets? Illustrate the difference.

6 marks

SECTION B – Select and Answer any THREE (3) questions from this section. Total Possible Marks = 60 marks

Question 3 (Total possible marks = 20 marks)

Big Boy Limited has provided you with the following information as at 31 December 2011:

	$000	
12% Bonds ($1 000 par value)		10 000
15% Preference Shares ($50 par)	8 000	
Ordinary Share Capital ($10 par)		50 000
Retained Profit	12 000	
	80 000	

The management of the company considers the current capital structure to be optimal and Big Boy Limited can raise $50 million required for investment as below:

Bonds

New 14% bonds ($1 000 par value) can be issued at a price of $920 after floatation costs.

Preference Shares

Current market price per share is $75. 15% preference shares can be issued at the same market price. Floatation costs will be 12%.

Ordinary Shares

The ordinary shares, whose Beta factor is 1. 4, are currently trading at $64. Dividends of $5 per share for the year to 31 December 2009 have just been paid. Dividends have been growing at a constant rate of 9% and management believes that new shares can be issued at a net price of $60 per share.

The risk – free rate is 8%, expected market returns 15% and corporate tax is at a rate of 30%.

Required

A. Compute the cost of each of the three sources of finance. Determine the cost of equity using both the dividend growth model and the capital asset pricing model approach.

10 marks

B. Determine the weighted average cost of capital of the company and clearly explain its importance (use the cost of equity as determined by the dividend growth model).

5 marks

C. The level of gearing has no effect on the cost of capital. Discuss this statement in view of the Traditional Theory and the MM theory.

5 marks

Question 4 (Total Possible Marks = 20 Marks)

Investigations into the issue of the annual published financial reports of companies by shareholders have shown the report as an important source of information for making decisions on equity investments. Other studies show that the market price of the shares in a company does not react in the short term to the publication of the company's annual report.

Explain these findings in view of the Efficient Market Hypothesis (EMH).

10 Marks

Briefly explain any five methods through which a company may obtain a listing of its shares on the stock exchange.

10 Marks

Question 5 (Total possible marks = 20 marks)

Given below is information relevant for Madela Ltd:

Level of operating income $1 800 000

Tax rate 40%

In an effort to determine the optimal capital structure, the firm has assembled data on the cost of debt, the number of shares for various levels of indebtedness and the overall required return on equity as detailed below for a total capital employed of $10 million.

Total Debt Ratio (%)	**Cost of debt (%)**	**No. of ordinary shares**	**Required Return on Equity (%)**

0	0	200 000	12
15	8	170 000	13
30	9	140 000	14
45	12	110 000	16
60	15	80 000	20

It is the objective of the firm to maximize the value of the ordinary share based on the Earnings Yield Valuation method where the value per share P_0 is given by:

$$P_0 = EPS/ K$$

Required

a) Compute the EPS for each level of indebtedness or proposed capital structure.

10 marks

b) Advise the company on the optimal capital structure to achieve the objective.

2 marks

c) Clearly distinguish between operating leverage and financial leverage.

8 marks

Question 6 (Total possible marks = 20 marks)

X Ltd has an issued ordinary share capital of $10 million represented by 400 000 shares of $25 each. In addition the company has in issue $3 million of 12% debentures. The shares are trading on the stock market at a price of $43, 26. It needs to raise $5 million to finance a new investment. Two alternatives have to be evaluated:

Alternative 1: make a rights issue at a price of $32 per share.
Alternative 2: borrow the funds from the bank at an interest rate of 23% per annum for 5 years.

Currently the company earns an operating income of $2, 5 million per annum and the new project is expected to generate an additional operating income of $900 000 per annum. Corporate tax is 40%.

You are required to:

i. Assuming the funds were raised through a rights issue, determine the ex – right price per share.

3 ***marks***

ii. Advise the company on the best alternative to adopt should their objective be to maximize their EPS.
8 marks

iii. In view of your analysis above, comment on the statement that 'a company should finance its operations using debt as it's a cheaper source of finance.'
4 ***marks***

iv. Assuming that the funds were raised through a loan, amortize the loan.
5 marks

END OF PAPER