KASNEB

CPA

FINANCIAL MANAGEMENT

27TH MAY 2015

QUESTION ONE

a) Explain the following terms as used in finance:

i. Financial engineering (2 marks)

ii. Financial contagion (2 marks)

iii. Money laundering (2 marks)

b) Larry Ltd has 3,200,000 ordinary shares each selling at a market price of Sh. 75. The management of the company contemplates raising additional finance through a rights issue to fund a new project worth Sh. 120,000,000.

The new shares would be offered at a discount of 20% to existing shareholders.

Required:

i. The number of rights required to buy one new share (2 marks)

ii. Theoretical ex-rights price (3 marks)

iii. The value of one right (2 marks)

c) Wesa Limited expects to pay a dividend per share of Sh. 7 next year which is expected to grow at a rate of 6% per annum. The company's is to retain 30% of its earnings. The cost of capital is 10%.

Required:

i. The expected earnings per share (EPS) next year (2 marks)

ii. The return on equity (ROE) (2 marks)

iii. The value of growth opportunities (3 marks)

(Total: 20 marks)

QUESTION TWO

a) Highlight four ways in which a company could reduce its working capital cycle. (4 marks)

b) Maweni limited is in the process of determining the optimal cash levels it should hold in the next financial year 2015/2016. The finance department has established that the annual cash requirement for the company is Sh. 2,500 million. The fixed cost of selling securities to raise cash per transaction is Sh. 500. The opportunity cost of holding cash is 12%.

Required:

Using the Bamol model of cash management, determine:

i) The optimal cash balance that the company should hold (3 marks)

ii) The total cost of maintaining the cash balance (3 marks)

c) Lenna Limited is currently issuing 9% bonds redeemable at Sh. 100 par value in five years' time. Alternatively, each bond may be converted on that date into 20 ordinary shares of the company. The current market price per share is Sh. 4.45 and this is expected to grow at the rate of 6.5% per annum for the foreseeable future. The company's cost of debt is 7% per annum.

Required:

i. Market value of the bond (4 marks)

ii. Floor value of the bond (3 marks)

iii. Conversion premium per share (3 marks)

(Total: 20 marks)

QUESTION THREE

a) Sally Chemicals Ltd is considering replacing a production machine at its plant in the industrial area. The existing production machine at the plant was bought 3 years ago at a cost of Sh. 50 million with an expected useful life of 8 years with no scrap value at the end of this period. The existing machine could be disposed of immediately with net proceeds of Sh. 35 million after tax. The new machine will cost the company Sh. 80 million with a useful life of 5 years and an expected terminal value of Sh. 5 million. Additional installation cost for the new machine will be Sh. 6 million.

With the introduction of the new machine, sales are expected to increase by Sh. 25 million per annum over the next five years. However, electricity costs will increase by Sh. 400,000 per annum. The contribution margin will be 40% and the corporate tax rate is at 30%.
The operation of the new machine will also require an immediate investment of Sh. 8 million in working capital which will be recovered at the end of its useful life. The company uses the straight line method of depreciation.
The company's cost of capital is 12%. Ignore capital gains.

Required:

i. The initial cash outflow for the replacement decision. (2 marks)

ii. Using the net present value (NPV) criteria, advise the management of Sally Chemicals Ltd on whether to replace the machine. (8 marks)

b) The following data was extracted from the financial statements Mwembeswere manufacturing Ltd for the year ended 31 December 2014.

Gross profit margin	25%
Current ratio	1.6:1
Debt-asset ratio	0.6:1
Inventory turnover	6 times
Total asstes turnover	1.2 times
Average collection period	40 days
Number of days in a year	365

Additional information

	Sh.
Cash at hand	32,720
Cash in bank	25,000
Trade payables	120,000
Equity capital	600,000
Total sales	1,800,000
Current portion of long-term borrowing	20,000

Required:

Statement of financial position as at 31 December 2014 (10 marks)

(Total: 20 marks)

QUESTION FOUR

a) Explain the following theories of capital structure and dividends:

i. Pecking order theory (3 marks)

ii. Bird-in-hand theory (3 marks)

b) The capital structure of Ndewa Limited is given below:

		Sh. "million"
6,000,000 fully paid ordinary shares		60
Retained earnings		40
2,000,000 8% preference shares	30	
400,000 10% long term debentures		70
		<u>200</u>

The company intends to raise additional finance as follows:

Sh. 50,000,000 from issuing 8% debentures
Sh. 40,000,000 from selling new ordinary shares at a flotation cost of Sh. 2 per share

The current market value of each ordinary share is Sh. 40. The shareholders expect a dividend of Sh. 5 share next year. The dividends grow at the rate of 12% per annum into perpetuity.
The debentures of the company have a face value of Sh. 100 each with market value of Sh. 150.
The company's tax rte is 30%.

Required:

i. The company's weighted average cost of capital (WACC) (4 marks)

ii. The marginal cost of capital (2 marks)

c) Kalama Works Ltd is considering expansion of its plant capacity to meet the growing demand of its plastic products. The company would finance the expansion programme to Sh. 160 million with either oft he two plans below:

Plan A: To finance the programmes with issue of 15% debentures.
Plan B: To issue 10 million equity shares at a market price of Sh. 16 per share.
The company's income statement before the expansion is given below:

	Sh. "million"
Sales	1,500
Less: Costs	1,050
Earnings before interest and tax **(EBIT)**	450
Interest on debenture (15%)	50
Profit before tax (PBT)	400
Tax @ 30%	120

Profit after tax (PAT)	280
Number of shares (in millions)	50
Earnings per share (Sh.)	5.6

Additional information

The company expects earnings before interest and tax with associated probabilities after expansion as follows:

Earnings before interest and tax (Sh. "million")	**Probability**
250	0.1
450	0.3
540	0.5
630	0.1

Required:

The expected earnings per share (EPS) for each plan. (8 marks)

(Total: 20 marks)

QUESTION FIVE

a) Differentiate between the following sets of terms as used in public finance:

i. "Debt redemption" and "debt repudiation" (3 marks)

ii. "Debt refinancing" and "debt rescheduling" (3 marks)

b) Explain three factors that lead to financial innovation in the economy of your country. (6 marks)

c) The data below relate to the financial performance of XYZ Limited for the year ended 31 December 2014:

	Sh. "000"
Earnings before interest and tax (EBIT)	4,480
Profit before tax (PBT)	1,280
Fixed costs	2,800

Required:

i. Degree of operating leverage (2 marks)

ii. Degree of financial leverage (1 mark)

iii. Degree of combined leverage (2 marks)

iv. Percentage change in earnings per share if sales increase by 5%. (3 marks)

(Total: 20 marks)