



The Co-operative University of Kenya

END OF SEMESTER EXAMINATIONS DECEMBER-2019

EXAMINATION FOR THE DEGREE OF BACHELOR OF COMMERCE

(YR IV SEM II)

UNIT CODE: HBF 2302

UNIT TITLE: ADVANCED FINANCIAL MANAGEMENT

DATE: 9th DECEMBER 2019

TIME: 9:00 AM – 11:00 AM

INSTRUCTIONS:

- Answer question **ONE (compulsory)** and any other **TWO** questions

QUESTION ONE

- (a) Explain how sensitivity and scenario analysis can be used to assess the stand-alone risk of a capital project (6 marks)
- (b) Discuss the efficient frontier with respect to investments in portfolio theory (6 marks)
- (c) Highlight any **FIVE** the factors that determine the optimal working capital in a firm (5 marks)
- (d) The information below relates to cashflows for two years for project-suswa, an independent project of the famous SGR(Sugoi Gambling Reinvented). The projects initial cash outlay is Sh 100,000 with a cost of capital of 12%.

Year 1		Year 2	
Cashflow	Probability	Cashflow	Probability
60,000	0.3	50,000	0.3
		60,000	0.5
		70,000	0.2
80,000	0.4	60,000	0.3
		80,000	0.5
		100,000	0.2
100,000	0.3	80,000	0.3
		100,000	0.5
		120,000	0.2

Required:Using decision tree analysis determine:

- i). The projects expected monetary value (EMV) (7 marks)
- ii). The projects NPV (6 marks)

QUESTION TWO

- (a) Explain the costs of financial distress and their effect on the capital structure. (3 marks)

- (b) Briefly explain how inflation affects capital budgeting analysis (4 marks)
 (c) Highlight any **FIVE** principles of capital Budgeting (5 marks)
 (d) Mr. Kajohnie the financial manager of Friends-With-Benefit Ltd

is considering investing in a risky project which would be added to an existing portfolio.

Securities D, E and F have the following characteristics with respect to expected return, standard deviation and correlation coefficients.

Security	Expected Return	Standard Deviation	Correlation Coefficients		
			D	E	F
D	0.08	0.02	0.4	0.6	
E	0.15	0.16	0.4		0.8
F	0.12	0.08	0.6	0.8	

Required:

Compute the expected rate of return and standard deviation of a portfolio comprised of equal investment in each security. (8 marks)

(a)

QUESTION THREE

- i). Define and differentiate Optimal capital structure and Target Capital structure (2 marks)
- ii). Discuss the implications of MM's propositions with no taxes, MM's Proposition with Taxes and the static trade-off theory on managerial decision making. (6 marks)
- iii). Explain the Perking order theory with respect to capital structure (4 marks)
- iv). Company Beta is considering investing in a project which has a three-year life. The project would involve an initial investment of Sh.20 million. The finance manager has come up with expected probabilities for various possible economic conditions as follows:

Year	Economic Conditions	Sh.'000' Net cash flows	Probability
0		(20,000)	1.0
1	High growth	10,000	0.2
	Average growth	6,000	0.7
	No growth	2,000	0.1
2	High growth	12,000	0.3
	Average growth	8,000	0.5
	No growth	4,000	0.2
3	High growth	16,000	0.4
	Average growth	12,000	0.3
	No growth	6,000	0.3

Required: Assuming a discount rate of 12%, advise whether company Beta invest in the project (8 marks)

QUESTION FOUR

- (a) Discuss the efficient frontier with respect to investments in portfolio theory (4 marks)

- (b) Explain any THREE dividend policies that firms use (6 marks)
- (c) Explain the any FOUR determinants of the choice between paying cash dividends and repurchasing shares (4 marks)
- (d) Discuss any TWO dividend theories and explain their relevance in the modern-day firms. (6 marks)

QUESTION FIVE

Evans Industries wishes to select the best of three possible mutually exclusive machines, each of which is expected to satisfy the firm’s ongoing need for additional aluminum-extrusion capacity. The three machines—A, B, and C—are equally risky. The firm plans to use a 12% cost of capital to evaluate each of them. The initial investment and annual cash inflows over the life of each machine are shown in the following table.

	Machine A	Machine B	Machine C
Initial investment (CF₀)	92,000	65,000	100,500
Year (t)	Cashflows (CF_t)		
1	12,000	10,000	30,000
2	12,000	20,000	30,000
3	12,000	30,000	30,000
4	12,000	40,000	30,000
5	12,000	---	30,000
6	12,000	---	---

Required:

- i). Based on the net present value advise the firm on the feasibility of the projects(6 marks)
- ii). Calculate the Modified Internal rate of Return for each of the projects (3 marks)
- iii). If the firm had a total of Sh 170,000 advise the firm on which projects to undertake (3 marks)
- iv). Evaluate these projects using both the least common multiple and the Equivalent annual annuity approaches and advise a hypothetical investor on which machine to choose (8 marks)