

Instructions to candidates

Total time duration: two (02) hours

Number of questions: four (04) Essay questions

Mark allocation: 100

Use of Non-programmable calculators is only permitted.

Answer all the questions.

1.
 - a. Distinguish between 'Wealth maximization' and 'Profit maximization'. (6 mark)
 - b. "Financial strategy is the aspect of strategy which falls within the scope of financial management, which will include decisions on investment, financing and dividends."
State the three (03) key decisions of financial strategy and discuss the inter-relationship between each decision with the aid of examples. (9 mark)
 - c. "A rupee in hand today is worth more than a rupee promised at some time in the future".
Discuss the validity of the above statement. (6 mark)
 - d. You can afford to pay Rs.25,000 per month, for a period of three (03) years, to invest in a new vehicle. You call up your local bank and find out that the going rate is 12% per annum.
What is the value of the vehicle that you can buy? (4 mark)
(25 mark)
2.
 - a. The B PLC has 1.4 million shares of stocks (ordinary shares) in issue. The market price of the stock is Rs.20 per share. The firm's debt is publicly traded and was recently quoted at 93 percent of face value. It has a total face value of Rs.5 million, and it is currently priced to yield 11%. The risk-free rate is 8 percent, and the market risk premium is 7%. It is estimated that beta (β) value of B PLC is .74. If the corporate tax rate is 34 percent, what is the WACC (based on market prices) of B PLC? (8 mark)
 - b. Explain the 'Modigliani and Miller view (1958) without tax'. (3 mark)
 - c. Briefly explain the disadvantages of 'Modigliani and Miller view' in (b) above. (4 mark)
 - d. X company is identical in all operating and risk characteristics to Y company, except that X company is all equity financed and Y company is financed by equity valued at Rs.2.1mn



and debt valued at Rs.0.9mn based on market values. X company and Y company operate in a country where no tax is payable.

The interest paid on Y company's debt is Rs.72,000 per annum, and it pays Rs.378,000 dividend to shareholders per annum. X company pays an annual dividend of Rs.450,000.

You are required to calculate,

- i. the value of X company. (2 mark)
 - ii. the cost of capital for X company. (2 mark)
 - iii. the cost of equity for Y company. (2 mark)
 - iv. the cost of debt for Y Company. (2 mark)
 - v. the weighted average cost (WACC) of Y company. (2 mark)
- (25 mark)

3.

- a. Briefly explain the Capital Assets Pricing Model (CAPM) and its disadvantages. (6 mark)
 - b. "Equity is said to be the most expensive source of finance". Discuss the validity of this statement. (6 mark)
 - c. BF Company Ltd pays a dividend of Rs.2.20 per share currently. The company is expected to maintain a 15% growth rate for the next three years and then to keep a constant growth rate of 8% indefinitely. If the Required rate of return on the equity of the company is 12%, what will be the value of the share? (Round your answer to two decimal places) (6 mark)
 - d. Briefly explain the weaknesses of the estimation you calculated in (d.) above. (7 mark)
- (25 mark)

4. BB Ltd is an internet service provider and also stores and transmits client data over the internet via its server infrastructure.

Because of technical advances in information technology, the existing server infrastructure will shortly become obsolete, and the company is considering what to do. The server infrastructure has been fully written off (book value is Rs.0) but has a scrap value of Rs. 8,000. A technical consultant hired at a cost of Rs.20,000 prepared a report outlining the possible replacement server infrastructures which are available on the market.

Now the company is considering on buying a new server infrastructure for Rs.150,000 to replace the existing one. The new server infrastructure could be sold for Rs.30,000 at the end of fifth year, the year in which the new server infrastructure is likely to be obsolete. Working capital requirement would be Rs.5,000 if the new infrastructure is installed, and would be recovered in full in the fifth year.

The estimated cash flows (before depreciation and tax) for the next five years are as follows;

Year	Existing infrastructure Rs '000'	New infrastructure Rs '000'
1	30	50
2	30	60
3	30	70
4	30	90
5	30	100

BB Ltd incurs 30% tax on corporate profits. The tax is to be paid in two equal installments: one in the year that profits are earned and the other in the following year. The company attracts tax depreciation allowances at 25% each year on reducing balance basis.

You can assume that all cash flows occur at the end of each year unless otherwise stated. All the cash flow are in actual/nominal terms. BB Ltd's discount rate (nominal rate) is 12%. Inflation rate is 2%.

Required,

- a. Calculate the Net Present Value (NPV), to the nearest whole number, if the new infrastructure is installed. (12 mark)
- b. Calculate the Net Present Value (NPV), to the nearest whole number, if the existing infrastructure is used. (8 mark)
- c. Advise senior management on whether to purchase of new server infrastructure or not. Justify your answer. (5 mark)
(25 mark)

