



Uva Wellassa University

Faculty of Management

Degree of Bachelor of Business Management in Entrepreneurship and Management

3rd YEAR 1st SEMESTER EXAMINATION – MARCH/APRIL 2013

EMG 302-2 Financial Management



Total marks for part C : 50

Answer all questions

01.

i. If the use of financial leverage magnifies the earning per share under favorable economic conditions, why do companies not employ very large amount of debt in their capital structures? Explain (5 Marks)

ii. The AFC Insurance Company is considering to change their operational process and that will alter the firm's cost structure in favor of fixed costs, while the loan will move the capital structure in the direction of more debt. The firm's leverage positions at expected output levels with and without the project are summarized as follows.

	DOL	DFL
Current	2.0	1.5
Proposed	3.0	2.0

The economic outlook is uncertain and some managers fear a decline in sales of as much as 10% in the coming year. Evaluate the effect of the proposed project on risk in financial performance. (5 Marks)

iii. Selected income statement and capital information for the Peoples' Insurance Company as follow (Rs 000):

Revenue	5,580	Capital	
Cost/Expenses	<u>4,200</u>	Debt	1,000
EBIT	<u>1,380</u>	Equity	<u>7,000</u>
		Total	<u>8,000</u>

Currently 700,000 shares of common stock are outstanding. The firm pays 15% interest on its debt and anticipates that it can borrow as much as it reasonably needs at that rate. The income tax rate is 40%.

The Company is interested in boosting the price of its stock. To do that management is considering restructuring capital to 50% debt in the hope that the increased EPS will have a positive effect on price. However, the economic outlook is shaky, and the company's CFO



thinks there's a good chance that deterioration in business conditions will reduce EBIT next year. At the moment Company's stock sells for its book value of Rs.10 per share.

- a. Estimate the effect of the proposed restructuring on EPS. (5 Marks)
 - b. Assess the increase in risk that will come along with it by using the degree of financial leverage (5 Marks)
- (Total Marks 20)

02.

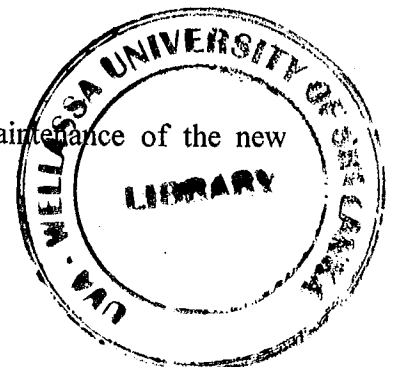
- i. What is capital budgeting? Why it is significant for a firm? (5 Marks)
- ii. ABC Insurance Company has two special marketing divisions which are periodically assisted by teams of visiting consultants. The management is worried about the study increase of expenses in this regard over the years. An analysis of the last year expenses reveals the following:

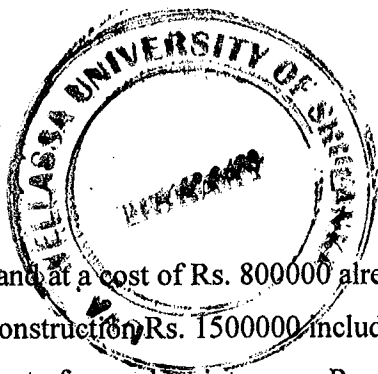
Consultants Remunerations	Rs. 250,000
Travel and Conveyance	Rs. 150,000
Accommodation Expenses	Rs. 600,000
Boarding Charges	Rs. 200,000
Special Allowances	Rs. 50,000

The management estimates accommodation expenses to increase by Rs. 200000 annually.

As part of cost reduction drive ABC Limited is proposing to construct a consultancy centre to take care of the accommodation requirements of the consultants. This centre will additionally save the company Rs. 50000 in boarding charges and Rs. 200000 cost of executive training program hitherto conducted outside the company premises every year.

The following details are available regarding the construction and maintenance of the new centre.





- a) Land at a cost of Rs. 800000 already owned by the company will be used.
- b) Construction Rs. 1500000 including special furnishing.
- c) Cost of annual maintenance Rs. 150000
- d) Construction cost will be written off (at a uniform rate) over five years being the useful life.

Assuming that the write off of the construction cost as aforesaid will be accepted for tax purposes, that the rate of tax will be 35% and that the desired rate of return is 15%. You are required to analyze the feasibility of the proposal and make recommendations.

(10 Marks)

(Total Marks 15)

03.

- i. Suppose stock in Toyota Corporation has a beta of 0.80. The market risk premium is 6%, and the risk free rate is 6%. What is Toyota's cost of equity capital. (3 Marks)
- ii. In addition to the information given in the previous problem, suppose Toyota has a target debt-equity ratio of 50%. Its cost of debt is 9%, before taxes. If the tax rate is 35%, what is WACC? (3 Marks)
- iii. ABC Insurance company wants to calculate its weighted average cost of capital(WACC). The company's chief finance officer (CFO) has collected the following information.
 - The company's long-term bonds currently offer a yield to maturity of 8 percent
 - The company's stock price is Rs.32 per share ($P_0 = \text{Rs.}32$)
 - The company recently paid a dividend of Rs.2 per share. ($D_0 = \text{Rs.}2$)
 - The dividend is expected to grow at a constant rate of 6 percent a year. ($g = 6\%$)
 - The company pays a 10 percent flotation cost whenever it issues new common stocks. ($F = 10\%$)
 - The company's target capital structure is 75 percent equity and 25 percent debt.
 - The company's tax rate is 40 percent.
 - The company anticipates issuing new common stock during the upcoming year.

You are required to: Calculate the WACC

(9 Marks)

(Total Marks 15)