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INTERNATIONAL COLLEGE PENANG (507232-U)
LAUREATE INTERNATIONAL UNIVERSITIES

FINAL
Examination Paper

(COVER PAGE)

Session : AUGUST 2015

Programme : DIPLOMA IN FINANCE

Course : **FIN2150: FINANCILA MANAGEMENT**

Date of Examination : 10 Dec 2015 (Thursday)

Time : 8:00am – 10:00am Reading Time : Nil

Duration : 2 Hours

Special Instructions :

This paper consists of **SIX(6)** questions. Answer any **FOUR (4)** questions in the answer in answer booklet provided. All questions carry equal marks

Materials permitted :

Nil

Materials provided :

Nil

Examiner(s) : **Ms. Suzanna Yew Cheng Pin**

Moderator : **Dr. Song Saw Im**

This paper consists of 5 printed pages, including the cover page.

INTI INTERNATIONAL COLLEGE PENANG
 DIPLOMA IN FINANCE
 FIN2150 FINANCIAL MANAGEMENT
 FINAL EXAMINATION : AUGUST 2015 SESSION

This paper consists of **SIX (6)** questions. Answer any **FOUR (4)** questions in the answer booklet provided. All questions carry equal marks.

Question 1

Finnex Corp. has two main operating divisions. One trades as a chain of drugstores and the other division manufactures garden furniture. The company is financed both by debt and equity capital.

The total market value of the company's equity is \$45.45 million ex-dividend. The company has recently paid dividends for the current year which totaled \$6 million and dividends are expected to grow at a constant rate of 7.5% per annum.

The company also has in issue 8.5% irredeemable debt with a total market value of \$15.15 million ex-interest. Its market price is \$80, par value is \$100.

The drugstore sector has an average beta of 0.88 and garden furniture manufacturers have an average beta of 2.10. The risk-free rate of return is 7% and the market return is 15%.

Finnex Corp. uses its weighted average cost of capital to evaluate all projects.

Required:

- (a) Calculate the
- (i) Cost of equity
 - (ii) Cost of debt
- (5 marks)
- (b) Determine the company's WACC. (4 marks)
- (c) Using the Capital Asset Pricing Model, compute the required rate of return for the
- (i) Drugstore division
 - (ii) Garden furniture division
- (6 marks)
- (d) The company is planning to expand its garden furniture division and is evaluating the desirability of using equity financing over long term debt financing.
- (i) Discuss **TWO (2)** advantages of **each type** of financing over the other
 - (ii) Suggest, with a reason, which type of financing you think would be suitable for Finnex Corp's garden furniture division.
- (10 marks)

(Total 25 marks)

Question 2

Eldman Co. is currently considering a single capital investment project. The company has sufficient financial resources to undertake the project which will not affect any other part of the company's business.

The project will involve initial capital outlay of \$3,700,000 and its cash flow returns are expected to be:-

<u>Year</u>	<u>Cash Flow</u>
1-3	\$1,200,000
4-6	800,000

The project will have a six-year life at the end of which it will be closed down and sold realizing scrap proceeds of \$250,000.

The company's directors ask you to advise them regarding the viability of the project from the financial perspective. They have the following criteria which potential investments must satisfy:-

1. Any project to be undertaken must yield a positive net present value when discounted at 15%.
2. Any project must be excluded if it yields less than 17% when measured by the internal rate of return.

Required:

- (a) Determine the project's
 - (i) Payback period (4 marks)
 - (ii) Net present value (6 marks)
 - (iii) Internal rate of return (7 marks)
- (b) Advise the directors as to whether or not the project should be undertaken on the basis of the criteria they have laid down. (4 marks)
- (c) In comparing the appraisal techniques above, which method would you consider be the most useful in enabling management to make the right financial decision to maximize shareholders' wealth? Give **TWO (2)** reasons. (4 marks)

(Total 25 marks)

Question 3

- (a) A company offers standard credit terms of 60 days. As it is currently experiencing some cash flow problems, it has decided to offer a 1.75% cash discount to customers for payments made within 10 days.

Its overdraft interest rate is 12% p.a. If customers usually take 65 days' credit, would the discount be a worthwhile option to consider in improving the company's liquidity?

Give your recommendation with reasons. (9 marks)

- (b) What steps might managers of a business take to improve company liquidity if they found that debtors were paying more slowly than anticipated?
Give **THREE (3)** suggestions. (6 marks)
- (c) Wirana Co. purchases material XY123, which costs \$10 per unit, in order sizes of 2400 units. The total annual requirement of the material XY123 is 48,000 units. Its ordering cost is \$8 per order, and storage costs p.a. is 20% of the material cost.

Delivery time of material XY123 is between 2 - 3 days and usage of the materials is at the rate of 100 - 120 units per day. Safety stock of 200 units is maintained.

Required:

Calculate the

- (i) economic order quantity
(ii) number of orders to be placed a year, using EOQ
(iii) re-order level

Note: Round all your answers to **whole numbers**.

(10 marks)

(Total 25 marks)

Question 4

Mr. Ong has investments worth \$100,000 in Mystic Co. and is planning to invest another \$100,000 in a new company. His financial consultant has identified and recommended two companies, Vegas Co. & Paradise Co., for his selection to add to the existing portfolio.

The following data was presented to Mr. Ong.

	Expected Return	Standard Deviation of Returns
Mystic Co	18%	6.2
Vegas Co	15%	2.4
Paradise Co	17%	4.3
Combination:		Correlation Coefficient
Mystic Co & Vegas Co		0.82
Mystic Co & Paradise Co		0.17

Required:

- (a) (i) For **EACH of the two combinations** of existing investment with one new investment in a portfolio, calculate the
(1) expected returns of the portfolio
(2) standard deviation of the portfolio
(ii) Recommend the optimal combination, with reasons. (15 marks)
- (b) Explain to Mr. Ong how the risk of his investment portfolio can be further reduced. (4 marks)
- (c) Mr. Ong believes that there is a limit to the reduction of risk in his portfolio. Do you agree? Explain. (6 marks)

(Total 25 marks)

Question 5

- (a) Gro-Force Corp. has just paid a dividend of \$1.15 per share on its common stocks for the current year. Its earnings and dividends are expected to grow at 15% in the next two years, followed by a growth rate of 13% in the third year and at a constant rate of 6% thereafter.
The investors' required rate of return on the company's stock is 12%.

Required:

Calculate the value of the stock today. (9 marks)

- (b) Mr. J. Bond is considering buying Speck-Tacular Co.'s bonds which are currently traded in the market at \$800. The bonds have an annual coupon rate of 8%, with a par value of \$1,000 and a maturity period of 10 years. Interests are paid semi-annually.
If Mr. J. Bond requires a return of 12% on his investments, should he buy the bond? Why? (7 marks)
- (c) Discuss **FOUR (4)** features that differentiate between common stocks, preferred stocks and bonds when making comparison between the three types of capital. (9 marks)

(Total 25 marks)

Question 6

- (a) In analyzing the accounts of two companies, Ms. R. Mazed finds that although both companies have the same amount of earnings before interest & tax and total capital employed, the company which is highly geared produces a higher EPS than the other which is lowly geared.

Hence, Ms. R. Mazed has come to the conclusion that a highly geared company would be able to increase shareholder wealth better than a lowly geared company.

- (i) Explain, with illustration, why a highly geared company shows a higher EPS than a lowly geared company. Indicate the situation in which this would be true.
- (ii) Do you agree with Ms. R. Mazed's conclusion? Discuss and illustrate your point of view. (13 marks)
- (b) Discuss Ms.R.Mazed's view in the light of the M & M capital structure theory. Does the firm's gearing have any impact on firm value and its weighted average cost of capital? Explain. (12 marks)

(Total 25 marks)