National University of Science and Technology

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING

SUPPLEMENTARY EXAMINATION PAPER: 2011/2012

DATE:	**JUNE 2012**
SUBJECT:	**FINANCIAL MANAGEMENT: CAC 4204**
TIME ALLOWED:	**THREE (3) HOURS**
MARKS:	**100**

INSTRUCTIONS TO CANDIDATES

1. Answer four (4) questions
2. Use the examination book provided
3. Use black or blue pen
4. Begin each question on a new page and
5. Submit all answer books
6. Maths tables are provided

QUESTION ONE [25 MARKS]

PINK plc is a long established entity with interests mainly in retailing and property development. Its current market capitalisation is US$750 million. The company trades almost exclusively in Zimbabwe, but is planning to expand overseas either by acquisition or joint venture within the next two years. The entity has built up a portfolio of investments in Zimbabwe equities and corporate and government debt. The aim of developing this investment portfolio is to provide a source of funds for its expansion programme. Summary information on the portfolio is given below:

Type of security	Value $million	Average % return over last 12 months
Zimbabwe equities	23.2	15
US equities	9.4	13.5
Zimbabwe corporate bonds	5.3	8.2
Long term government bonds	11.4	7.4
3-months treasury bonds	3.2	6.0

Approximately 25% of the Zimbabwe equities are in small entities' shares, some of them trading on the Alternative Investment Market. The average return on all Zimbabwe equities over the past 12 months has been 12%. On US it has been 12.5%.

Ignore taxation throughout this question.

REQUIRED:

(a) Discuss the advantages and disadvantages of holding such a portfolio of investments in the circumstances of PINK plc. **[12]**

(b) One of PINK plc's corporate debt investments is $50,000 nominal in a convertible bond 1997-1999, currently selling at $106.50 per $100 of stock. The coupon rate is 6%. If not converted it is repayable on 31 December 1999 at par. Interest is payable annually and has just been paid for 1997. Bonds of similar risk without a conversion feature are currently selling to return 7%.

The 1997 date for conversion is 31 December 1997 at a conversion ratio of 20 shares per $100 of stock. The ratio applicable for conversion in 1998 is 18 shares per $100 of stock. The market price of the ordinary shares is 540c. At the time the bonds were purchased by PINK plc in 1996, the equity share price was 480c. Assume that interest rates have remained unchanged since the bonds were purchased.

You are required to:

(i) Explain what is meant by the terms conversion premium and conversion discount. **[6]**

(ii) Advise the company's treasurer about the factors to consider before deciding whether to convert the bond in 1997 or 1998. Include all relevant calculations in your advice. **[7]**

QUESTION TWO [25 MARKS]

RED is a family run and owned company based in UK which designs and manufactures state of the art vacuum cleaners. It has grown steadily during the eight years since it was founded and the directors consider that the company is now of a suitable size to be listed on the Alternative Investment market (AIM), which is a market for the shares of smaller companies.

The company is currently in the early stages of development of a new product that it is hoped will be highly successful and will significantly increase the company's share of the vacuum cleaner market. Information about the product's development will be made public at various stages during 2012. Information may also become public knowledge through other means as more people and organisations become involved in the testing and implementation of production of the new product.

Significant amounts of new funding will be required to finance the final development, production and launch of this product but the existing shareholders are now not able to provide this. Therefore the directors of RED are planning to raise the necessary funds by means of a bond issue followed by an IPO towards the end of the year.

REQUIRED:

(a) Compare and contrast the features of a private placing and a public issue for the bonds and advise the directors of RED which method would be most appropriate. **[12]**

(b) Describe the three forms of the efficient market hypothesis and state which form is likely to apply in practice. **[6]**

(c) Advise the directors of RED on what steps can be taken to improve the chances of a successful Initial Public Offering (IPO) issue and a high share price after the issue. Your answer should include reference to the efficient market hypothesis**.[7]**

QUESTION THREE [25 MARKS]

When determining the financial objectives of a company, it is necessary to take three types of policy decisions into account and these are: investment policy, financing policy and dividend policy.

Required:

(a) Discuss the nature of these three types of policy decision, commenting on how they are interrelated and how they might affect the value of the firm (i.e. the present value of projected cash flows) **[15]**

(b) What does it mean to say that corporate managers “smooth” cash dividend payments? Why do managers do this? **[5]**

(c) What does it mean to say that dividends are “irrelevant” in a world without taxes or other market frictions? **[5]**

QUESTION FOUR [25 MARKS]

The directors of BIG plc wish to expand the entity’s operations. However, they are not prepared to borrow at the present time to finance capital investment. The directors have therefore decided to use the company’s cash resources for the expansion programme.

Three possible investment opportunities have been identified. Only $400 000 is available in cash, and the directors intend to limit their capital expenditure over the next 12 months to this amount. The projects are not divisible (i.e. cannot be scaled down) and none of them can be postponed. The following cash flows do not allow for inflation, which is expected to be 10% per annum constant for the foreseeable future. Expected net cash flows (including residual values):

PROJECT	INITIAL INVESTMENT	YEAR 1	YEAR 2	YEAR 3
	$	$	$	$
A	(350,000)	95,000	110,000	200,000
B	(105,000)	45,000	45,0000	45,000
C	(35,000)	(40,000)	(25,000)	125,000

Company shareholders currently require a return of 15% nominal on their investment. Ignore taxation.

REQUIRED:

(a) (i) Calculate the expected Net Present Value (NPVs) and Profitability Index (PIs) of the three projects. **[10]**

(ii) Comment on which project(s) should be chosen for investment, assuming the entity can invest surplus cash in the money market at 10%. **[8]**

Note: You should assume that the $400,000 expenditure limit is the absolute maximum the entity wishes to spend.

(b) Discuss whether the entity’s decision not to borrow, thereby limiting investment expenditure, is in the best interests of its stakeholders. **[7]**

END OF EXAMINATION PAPER