LAIKIPIA UNIVERSITY

UNIVERSITY EXAMINATIONS

2ND SEMESTER 2023/2024 ACADEMIC YEAR

SECOND YEAR EXAMINATION FOR THE DEGREE OF BACHELOR OF COMMERCE

BCOM 224/230: BUSINESS FINANCE

STREAM: ***TIME: 2 HRS***

DAY: TUESDAY [8.30-10.30 A.M] ***DATE: 16/04/2024***

THIS QUESTION PAPER CONSISTS OF FIVE (5) PAGES

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QUESTION ONE

a) Three years ago, Mrs. Rehema was retrenched from the Civil Service after the country adopted the IMF structural adjustment reforms. She invested substantially all her terminal benefits in the shares of XYZ Ltd., a company quoted on the stock exchange. The dividend payments from this investment make up a significant position of Mrs Rehema's income. She was alarmed when XYZ Ltd. dropped its year 2021 dividend to Sh.1.25 per share from Sh.1.75 per share which it had paid in the previous two years. Mrs Rehema has approached you for advice and you have gathered the information given below regarding the financial condition of XYZ Ltd. and the finance sector as a whole.

XYZ Ltd. Balance Sheets as at 31 October

	2019 Sh.'000'	2020 Sh.'000'	2021 Sh.'000'
Cash	15,250	14,400	8,000
Accounts receivable	80,320	87,800	134,400
Inventory	98,600	158,800	254,000
Total current assets	194,170	261,000	396,400
Land and buildings	25,230	27,600	25,000
Machinery	33,800	36,400	30,600
Other fixed assets	14,920	18,200	16,400
Total assets	268,120	343,200	468,400
Accounts and notes payable	34,220	73,760	135,848
Accruals	15,700	34,000	67,000
Total current liabilities	49,920	107,760	202,848
Long term debt	60,850	60,858	81,720
Ordinary share capital	115,000	115,000	115,000
Retained earnings	42,350	59,582	68,832
	268,120	343,200	468,400

XYZ Ltd. Income Statements for the year ending 31 October

	2019 Sh.'000'	2020 Sh.'000'	2021 Sh.'000'
Sales (all on credit)	827,000	858,000	890,000
Cost of sales	(661,600)	(710,000)	(712,000)
Gross profit	165,400	148,000	178,000
General administrative and selling expenses	(63,600)	(47,264)	(51,200)
Other operating expenses	(25,400)	(31,800)	(38,200)
Earnings before interest and tax (EBIT)	76,400	68,936	88,600
Interest expense	(12,800)	(26,800)	(63,600)
Net income before taxes	63,600	42,136	25,000
Taxes	(25,400)	(16,854)	(10,000)
Net income	38,200	25,282	15,000
Number of shares issued	4,600,000	4,600,000	4,600,000

Per share data:			
Earnings per share (EPS)	Sh. 8.30	Sh. 5.50	Sh. 3.26
Dividend per share	Sh. 1.75	Sh. 1.75	Sh. 1.25
Market price (average)	Sh.48.90	Sh.25.50	Sh.13.25

		Industry Financial Ratios (2001)
Quick ratio		1.0
Current ratio		2.7
Inventory turnover		7 times
Average collection period		32 days
Fixed asset turnover		13.0 times
Total assets turnover		2.6 times

		Industry Financial rations
Net income to net worth		1.8%
Net profit margin on sales		3.5%
Price-Earnings (P/E) ratio		6 times
Debt/Equity ratio		50%

Notes:
1) Industry ratios have been roughly constant for the past four years.
2) Inventory turnover, total assets turnover and fixed assets turnover are based on the year-end balance sheet figures.

Required:
a) The financial ratios for XYZ Ltd for the past three years corresponding to industry ratios given above. **(10 marks)**
b) Arrange the ratios calculated in (a) above in columnar form and summarize the strengths and weaknesses revealed by these ratios based on:
   i) Trends in the firm's ratios **(6 marks)**
   ii) Comparison with industry averages. **(6 marks)**
   (The summary should focus on the liquidity, profitability and turnover ratios).

b) Explain the difficulties faced in capital budgeting techniques **(8 Marks).**

QUESTION TWO (20 Marks).

From the following information, calculate the net present value of the two project and suggest which of the two projects should be accepted a discount rate of the two. **(12 Marks)**

	Project X	Project Y
Initial Investment	Shs.20,000	Shs.30,000
Estimated Life	5 years	5 years
Scrap Value	Shs/ 1,000	Shs.2,000

The profits before depreciation and after taxation (cash flows) are as follows:

	Year 1	Year 2	Year 3	Year 4	Year 5
Project x	5,000	10,000	10,000	3,000	2,000
Project Y	20,000	10,000	5,000	3,000	2,000

The following are the present value factors @ 10% p.a.

YEAR	**1**	**2**	**3**	**4**	**5**	**6**
FACTOR	0.909	0.826	0.751	0.683	0.621	0.564

QUESTION TWO

You borrow Shs.10, 000 for four years. The bank will lend you the money at 8% interest rate and will require that the loans are paid-off in four equal (end-of-year) installment payments.

a) Provide benefits of operating a partnership business **(2 Marks).**
b) Prepare a loan repayment schedule for this loan. **(6 Marks).**

QUESTION THREE

A company paid a dividend of Shs.250, 000 this year. The current return to shareholders of companies in the same industry is 12%, although it is expected that an additional risk premium of 2% will be applicable to the company, being a smaller and unquoted company. Compute the expected valuation of the company, if:

a) The current level of dividend is expected to continue into the foreseeable future, and **(6 Marks).**
b) The dividend is expected to grow at a rate of 4% pa into the foreseeable future. **(6 Marks).**
c) Highlight four factors that may hinder companies from being listed at the stock exchange. **(8 Marks).**

QUESTION FOUR

The Gamma Products Corporation has the following capital structure, which it considers optimal:

	Shs
Bonds, 7% (now selling at par)	300,000
Preferred Shares, Shs.5.00	240,000
Ordinary Shares	360,000
Retained earnings	300,000
	1,200,000

Dividends on ordinary shares are currently Shs.3 per share and are expected to grow at a constant rate of 6 percent. Market price per share of ordinary shares is Shs40, and the preferred stock is selling at Shs50. Flotation cost on new issues of ordinary shares is 10 percent. The interest on bonds is paid annually. The company's tax rate is 40 percent. Determine:

a) The cost of bonds; **(2 Marks).**
b) The cost of preferred stock; **(2 Marks).**
c) The cost of retained earnings (or internal equity); **(2 Marks).**
d) The cost of new ordinary shares (or external equity); and **(2 Marks).**
e) The weighted average cost of capital. **(8 Marks).**
f) Highlight disadvantages of partnership form of business. **(4 Marks)**