

UNIVERSITY OF FORT HARE

ADVANCED FINANCIAL
MANAGEMENT
BEC524/BEC524E

DEGREE EXAMINATIONS

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Time: 3 Hours
Subject: BEC524/BEC524E
Marks: 100

This paper consists of 4 pages including the cover page

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INSTRUCTIONS

Answer any four questions

This question paper consists of 4 pages including the cover page

Question 1a [25 marks]

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

Required:

Discuss the nature of these **THREE** types of decisions, commenting on how they are inter-related and how they might affect the value of the firm (that is the present value of projected cash flows) [15 Marks]

Question 1b

Why is it that, for a given firm, that the required rate of return on equity is always greater than the required rate of return on its debt? [5 marks]

Question 1c

The Blue Dog Company has common stock outstanding that has a current price of \$20 per share and a \$0.5 dividend. Blue Dog's dividends are expected to grow at a rate of 3% per year, forever. The expected risk-free rate of interest is 2.5%, whereas the expected market premium is 5%. The beta on Blue Dog's stock is 1.2.

What is the cost of equity for Blue Dog using the dividend valuation model? [2 marks]

What is the cost of equity for Blue Dog using the capital asset pricing model? [3 marks]

Question 2a [25 marks]

A firm has the following capital structure and after-tax costs for the different sources of funds used:

Sources of Funds	Amount (R)	Proportion (%)	After-tax Cost (%)
Debt	500 000	35	8
Preference Capital	400 000	25	12
Equity Capital	600 000	40	15
Total	1 500 000	100	

Calculate the weighted average cost of capital using book-value weights.

[5 Marks]

The firm wishes to raise further R 800 000 for the expansion of the project as below.

Debt	R 400 000 (cost of 10 after tax)
Preference Capital	R150 000 (cost of 15)
Equity Capital	R 250 000 (cost of 20)

Taking into consideration, the cost changes compute the weighted marginal cost of capital schedule.

[15 Marks]

Question 2b

Discuss how working capital affects both the liquidity and profitability of a business.

[5 marks]

Question 3 [25 marks]

- a. A company is considering two projects and can only accept one of them. The projected cash flows are as follows:

Year	Project A Cash Flow	Project B Cash Flow
0	-R10 000 000	-R15 000 000
1	R6 000 000	R10 000 000
2	R18 000 000	R21 700 000
3	R22 000 000	R35 000 000

The company's WACC is 10%. Compute the following for both projects:

- Discounted payback [8 marks]
- NPV [8 marks]
- Profitability index [4 marks]
- Which project should be chosen? Explain the logic behind your choice.

[5 marks]

Question 4 [25 marks]

Mr Macdonald places 40% of his funds in Security X, which has a return of 20% and 60% of his money in security Y that has a return of 25%. The standard deviation on Security X is 25% and on Y is 20% respectively.

- i. Calculate the expected return of the portfolio [4 marks]
- ii. Calculate the standard deviation for the portfolio if the correlation between the stocks is +0.4 [6 marks]
- iii. Discuss the reasons why unsystematic risk can be eliminated through diversification. [5 marks]
- ~~iv. Discuss the aggressive working capital management approach? Make use of diagrams to illustrate your answer. [10 marks]~~

Question 5 [25 marks]

- a) Discuss the concept of capital structure and with the aid of a diagram, discuss the pecking order theory of capital structure [15 marks]
- b) Moon Beam Industries has a debt-equity ratio of 1.5. Its WACC is 12 percent, and its cost of debt is 12 percent. The corporate tax rate is 35 percent. What is Moon Beam's cost of equity capital? [5 marks]
- c) Discuss the two main reasons why a company should use debt to finance a large portion of its business. [5 marks]

Question 6 [25 marks]

- a) Discuss any four methods of accelerating cash inflows in a business [10 marks]
- b) Briefly discuss the impact of inflation and a change in sales on working capital. [5 marks]
- c) When managing working capital there is a need to have a working capital trade off. Discuss the advantages and disadvantages of having high levels of inventory. [10 marks]