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CITY CAMPUS

MAIN EXAMINATION

AUGUST - DECEMBER 2014 TRIMESTER

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

EVENING PROGRAMME

CFI 425: STRATEGIC FINANCE MANAGEMENT

Date: DECEMBER 2014	**Duration: 2 Hours**
INSTRUCTIONS: Answer Question ONE and ANY OTHER TWO Questions	

Q1. a) Financial distress (insolvency) may force a company to restructure its capital. Briefly discuss:

i) Immediate insolvency **(6 marks)**
ii) Long-term insolvency **(6 marks)**

b) Hunter Ltd is contemplating to acquire all the shares of Victim Ltd. The following details represent the most recent position:

	Hunter Ltd	**Victim Ltd**
Number of shares outstanding	5.0 million	1.0 million
Market value per share	Sh. 20.00	Sh. 10.00
Cost of equity capital	14%	12%

Due to operational efficiency to result from the combination, Hunter expects an annual incremental cash flow of Sh. 1.92 million perpetually. The shareholders of Victim Ltd are asking of 20% premium on the current market value of their firm.

Required:

i) Synergy of the combination **(2 marks)**
ii) The NPV if the deal is on cash basis. **(3 marks)**
iii) NPV if Hunter issues 1.0 million of its new shares to Victim's shareholders in lieu of cash. **(2 marks)**

c) AB Ltd has Sh. 638.00 million average total annual sales with 73% variable cost ratio. The company has classified its customers into group A who are allowed credit and group B who are sold on cash basis. The latter contributes Sh. 200.00 million of the total annual sales of the company. The company's cost of capital is 16%. To improve performance AB Ltd is considering to introduce 1.5/10, n30 credit terms to group B customers. Expected results are:

- Group B sales to increase by Sh. 40 million.
- Bad debts for the group will be 1.2%
- 60% of all the group's customers will take the discount offer.
- Average debt collection period for the whole company will move from current 30 days to 36.5 days.

Required:

Advise the management. **(9 marks)**

Q2. a) Discuss the concept of synergy and the importance of its value in relation to combination of companies.

b) Speed Ltd operates in a growing market and has 2.0 million shares outstanding trading at Sh. 75.00 each. Stock Ltd, with 1.2 million shares outstanding is in a matured market paying annual dividends of Sh. 2.000 per share which is expected to remain constant to the foreseeable future. The cost of capital for both companies is 10%.

Speed Ltd is contemplating to acquire 100% of Stock Ltd. Expected results:

- Speed Ltd will increase its per-share dividend to Sh. 4.50 one year form date of combination and this will grow at 3% annually.
- Due to stabilized earnings, the cost of equity capital for he combined entity will drop to 8%.

Required: (Use Gordon's share valuation model)

i) Value of Synergy resulting from the combination.

ii) Net Present value (NPV) if:

1) Speed pays Sh. 28.00 million cash as consideration.
2) Speed issues its 400000 new shares to Stock Ltd shareholders as consideration.

Q3. a) Briefly discuss the term "Sustainable growth rate" of a firm. **(5 marks)**

b) ABC Ltd are compiling a financial plan for year 2. The following is an abstract of their balance sheet as at end of year 1.

Assets:	Sh. 000	**Finance by:**	Sh. 000
Current	3234	Current liabilities	2793
Fixed	4861	L/T liabilities	1736
		Owners' equity	3566
	8095		8095

Additional information:

i) Year 1 sales were Sh. 29.40 million and are expected to grow to Sh. 41.48 year 2.

ii) The fixed assets were working at 84% capacity during year 1.

iii) Fixed assets are available in the market only in batches of Sh. 0.40 million.

iv) Year 2 net income is estimated to be Sh. 2.10 million with a 60% dividend ratio.

Required:

i) External finance needed to fund the projected growth (Use proforma balance sheet). **(12 marks)**

ii) Assume ABC Ltd has always maintained an optimum debt/equity ratio and is not to issue more shares. Is the projected growth rate acceptable? (Show your calculations) **(3 marks)**

Q4. a) X Large Ltd is a substantially decentralized firm with various autonomous divisions and remunerates its divisional managers depending on annual performance of their respective divisions. Y division, with total investment of Sh. 20 million has had an average EBITof Sh. 2 million annually. There is a proposal to invest an additional Sh. 10 million in this division expected to generate an additional Sh. 0.7 million EBIT. The firm's cost of capital is 5% and is in a 10% profit tax bracket.

Required:

Evaluate acceptability of this proposal by the management of division Y using:

i) Return On Investment (ROI) and
ii) Economic Value Added (EVA) as the measure of performance. **(10 marks)**

b) Discuss the **FIVE** conditions that should hold for EVA to be an effective performance measurement tool for bonus remuneration purposes. **(10 marks)**

END