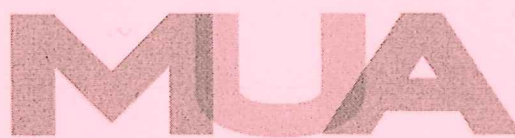


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POST GRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF MASTER OF BUSINESS ADMINISTRATION

**BFO 507: INTERNATIONAL FINANCIAL MANAGEMENT**

**DATE: 28<sup>TH</sup> NOVEMBER 2023**

**DURATION: 3 HOURS**

**MAXIMUM MARKS: 60**

**INSTRUCTIONS:**

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **FOUR (4)** questions.
4. Question **ONE** is **compulsory**.
5. Answer any other **TWO** questions.
6. Question **ONE** carries **30 MARKS** and the rest carry **15 MARKS** each.
7. Write all your answers in the Examination answer booklet provided

## QUESTION ONE

Read the Case Study below carefully and answer the questions that follow:

### DORCHESTER, LTD.

Dorchester Ltd. is an old-line confectioner specializing in high-quality chocolates. Through its facilities in the United Kingdom, Dorchester manufactures candies that it sells throughout Western Europe and North America (United States and Canada). With its current manufacturing facilities, Dorchester has been unable to supply the U.S. market with more than 225,000 pounds of candy per year. This supply has allowed its sales affiliate, located in Boston, to be able to penetrate the U.S. market no farther west than St. Louis and only as far south as Atlanta. Dorchester believes that a separate manufacturing facility located in the United States would allow it to supply the entire U.S. market and Canada (which presently accounts for 65,000 pounds per year). Dorchester currently estimates initial demand in the North American market at 390,000 pounds, with growth at a 5 percent annual rate. A separate manufacturing facility would, obviously, free up the amount currently shipped to the United States and Canada. But Dorchester believes that this is only a short-run problem. They believe the economic development taking place in Eastern Europe will allow it to sell there the full amount presently shipped to North America within a period of five years.

Dorchester presently realizes £3.00 per pound on its North American exports. Once the U.S. manufacturing facility is operating, Dorchester expects that it will be able to initially price its product at \$7.70 per pound. This price would represent an operating profit of \$4.40 per pound. Both sales price and operating costs are expected to keep track with the U.S. price level; U.S. inflation is forecast at a rate of 3 percent for the next several years. In

the U.K., long-run inflation is expected to be in the 4 to 5 percent range, depending on which economic service one follows. The current spot exchange rate is \$1.50/£1.00. Dorchester explicitly believes in PPP as the best means to forecast future exchange rates.

The manufacturing facility is expected to cost \$7,000,000. Dorchester plans to finance this amount by a combination of equity capital and debt. The plant will increase Dorchester's borrowing capacity by £2,000,000, and it plans only to borrow that amount. The local community in which Dorchester has decided to build will provide \$1,500,000 of debt financing for a period of seven years at 7.75 percent. The principal is to be repaid in equal installments over the life of the loan. At this point, Dorchester is uncertain whether to raise the remaining debt it desires through a domestic bond issue or a Eurodollar bond issue. It believes it can borrow pounds sterling at 10.75 percent per annum and dollars at 9.5 percent. Dorchester estimates its all-equity cost of capital to be 15 percent.

The U.S. Internal Revenue Service will allow Dorchester to depreciate the new facility over a seven year period. After that time the confectionery equipment, which accounts for the bulk of the investment, is expected to have substantial market value.

Dorchester does not expect to receive any special tax concessions. Further, because the corporate tax rates in the two countries are the same--35 percent in the U.K. and in the U.S.--transfer pricing strategies are ruled out.

### Required

- a) Conduct analysis to determine whether Dorchester should build the new manufacturing plant in the United States? **(10 Marks)**
- b) Evaluate the key factors contributing to effective cash management within a firm. Give reasons why the cash management process is more difficult in a multinational corporation? **(4 Marks)**
- c) Assess four reasons why international foreign trade is more difficult and risky from the exporter's perspective than is domestic trade **(8 Marks)**

d) Evaluate advantages of the Net Present Value method in Capital budgeting

(4 Marks)

e) Discuss Four implications of volatility of foreign exchange on multinationals

(4 marks)

## QUESTION TWO

a) Illustrate five major trends that have prevailed in international financial management during the last two decades. (10 Marks)

b) Evaluate how a country's economic well-being is enhanced through free international trade in goods and services (5 Marks)

## QUESTION THREE

a) Assess five factors that investors should consider before investing in the emerging stock market of a developing country (5 Marks).

b) Doug Bernard specializes in cross-rate arbitrage. He notices the following quotes:

Swiss franc/dollar = SFr1.5971/\$

Australian dollar/U.S. dollar = A\$1.8215/\$

Australian dollar/Swiss franc = A\$1.1440/SFr

**Required:**

i) Ignoring transaction costs, does Doug Bernard have an arbitrage opportunity based on these quotes? (4 Marks)

ii) If there is an arbitrage opportunity, what steps would he take to make an arbitrage profit, and how would he profit if he has \$1,000,000 available for this purpose. (6 Marks)

## QUESTION FOUR

a) "Empirical studies about factors affecting equity returns basically showed that

domestic factors were more important than international factors, and, secondly, that industrial membership of a firm was of little importance in forecasting the international correlation structure of a set of international stocks". Elaborate this statement. **(5 Marks)**

- b) Due to the integrated nature of their capital markets, investors in both the U.S. and U.K. require the same real interest rate, 2.5%, on their lending. There is a consensus in capital markets that the annual inflation rate is likely to be 3.5% in the U.S. and 1.5% in the U.K. for the next three years. The spot exchange rate is currently \$1.50/£.
- i. Compute the nominal interest rate per annum in both the U.S. and U.K., assuming that the Fisher effect holds. **(4 Marks)**
  - ii. Determine the expected future spot dollar-pound exchange rate in three years from now? **(3 Marks)**
  - iii. Can you infer the forward dollar-pound exchange rate for one-year maturity? **(3 Marks)**

