The Management University of Africa

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POST GRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF MASTER OF BUSINESS ADMINISTRATION

BFO 501: CORPORATE FINANCE

DATE: 30TH JULY 2026

DURATION: 2 HOURS

MAXIMUM MARKS: 70

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 **TTW0** 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:

INVESTMENT APPRAISAL OF NEW ANTI-DIABETES DRUG AT MATIBABTU PHARMACIA LTD

Matibabu Pharmacia Ltd., a leading pharmaceutical company, has recently completed the development of a new drug designed to reduce the effects of diabetes. The company has invested heavily in the project, incurring research and development costs amounting to Sh.160 million. To assess the commercial viability of the drug before making a launch decision, management commissioned an independent market research study at a cost of Sh.15 million. The research findings indicated that the drug is expected to remain commercially viable for four years before newer and more advanced treatments are introduced into the market.

According to the market report, the drug could initially be sold to authorized drug stores, hospitals, and chemists at a price of Sh.20 per 500mg capsule during its first year in the market. To reflect anticipated market acceptance and inflationary trends, the selling price is expected to increase by 20% annually after the first year. Management believes that the pricing strategy could help maintain profitability throughout the drug's economic life despite the increasing competition expected in the pharmaceutical industry.

Demand for the new drug remains uncertain, and therefore sales projections have been estimated using probability distributions. The independent researchers estimated that annual sales could reach 11 million capsules with a probability of 0.3, 14 million capsules with a probability of 0.6, or 16 million capsules with a probability of 0.1. These forecasts will play a critical role in evaluating the expected financial performance of the

project and determining whether the anticipated returns justify the investment.

If the company proceeds with the launch, production can begin immediately because the necessary manufacturing equipment is already available. The equipment was originally acquired at a cost of Sh.150 million. At the end of the drug's four-year life, the equipment is expected to have a disposal value of Sh.35 million. However, if management decides not to proceed with the drug launch, the equipment will have no alternative use within the company and can therefore be sold immediately for Sh.85 million.

The production process for the new drug requires two hours of direct labour for every 500mg capsule produced. Labour costs are estimated at Sh.4 per hour, and additional employees will need to be recruited specifically for the project. Since these workers are unlikely to be retained after the project ends, the company expects to incur redundancy costs amounting to Sh.10 million at the end of the fourth year. Furthermore, the ingredients required for each capsule will cost Sh.6, while additional overhead expenses directly attributable to the project are expected to be Sh.15 million annually.

To support operations, the company will also need to invest an additional Sh.2 million in working capital throughout the project's life. This working capital commitment will be recovered at the end of the fourth year. Management recognizes that working capital requirements are an important component of project evaluation because they represent funds tied up in day-to-day operations that could otherwise be invested elsewhere.

An additional strategic consideration concerns the ownership of the patent rights associated with the drug. The new product has generated significant interest among industry competitors. If Matibatu Pharmacia Ltd. decides against commercializing the drug, it has the option of selling the patent rights to Welo Kam (K) Ltd., one of its major competitors, for Sh.125 million. This alternative provides management with an opportunity cost that must be considered when evaluating the attractiveness of launching the drug.

The company's finance department has estimated a cost of capital of 12%, which represents the minimum return required by investors to compensate for the risks associated with the project. Consequently, any investment decision concerning the drug will be evaluated using discounted cash flow techniques to determine whether the project is expected to create value for shareholders. Particular attention will be given to the Expected Net Present Value (ENPV), which incorporates the probability distribution of future sales outcomes.

Management is aware that launching the drug involves balancing potential rewards against substantial risks. While the project offers an opportunity to strengthen the company's position in the growing diabetes treatment market, it also requires the commitment of resources that could be deployed elsewhere. The final decision will therefore depend on whether the expected future cash inflows generated by the project exceed the relevant costs, opportunity costs, and required rate of return.

Required:

a) (i) Compute Relevant Cash Flows and Expected Annual Cash Flow **(8 Marks)**

(ii)Calculate the Expected Net Present Value (ENPV) of launching the new anti-diabetes drug.

(8 Marks)

b) Based on your calculations and analysis, advice management on whether Matibabu Pharmacia Ltd. should launch the new drug. Give reasons for your recommendation.

(2 Marks)

c) Discuss one strength and one weakness of using the Expected Net Present Value (ENPV) approach when evaluating investment decisions under uncertainty.

(2 Marks)

d) Examine five factors that could influence the company's cost of capital and explain how each factor may affect future investment decisions.
(10 Marks)

QUESTION TWO

a) Corporate bonds have recently started gaining prominence as disintermediation financial instruments in developing countries.

i) Distinguish between financial intermediation and financial facilitation.
(4 Marks)

ii) Explain the relationship between the price of bonds and:

- Interest rates in the market generally. **(2 Marks)**
- Term to maturity of the bonds. **(3 Marks)**

b) Evaluate the three forms of informationally efficient capital markets. **(6 Marks)**

QUESTION THREE

a) Evaluate the reasons why multi-national companies (MNC) seek foreign investment. **(6 Marks)**

b) Ushindi Limited presented the following financial statements on 30 June 2023.

Income statement for the year ended 30 June 2023

	Sh.

Sales (all on credit)	4,000,000
Operating profit	440,000
Less: debenture interest	40,000
	400,000
Corporation tax	176,000
	224,000
Ordinary dividends proposed	107,200
Retained profit	116,800

Balance Sheet as at 30 June 2023

	Shs.	Shs.	Shs.
Fixed assets:			
Freehold property (Net book value)			480,000
Plant and machinery (Net book value)			800,000
Motor vehicle (Net book value)			200,000
Furniture and fittings			200,000
			1,680,000
Current assets:			
Stock		1,000,000	
Debtors		400,000	
Investments		120,000	
		1,520,000	
Current liabilities			
Trade creditors	238,400		
Bank overdraft	878,400		
Corporation tax	176,000		
Dividend payable	107,200	(1,400,000)	120,000
			1,800,000
Financed by:			
Authorized share capital: 800,000 Sh.1 ordinary shares			800,000
Issued and fully paid: 400,000 Sh.1 ordinary shares			400,000
Capital reserve			200,000
Revenue reserve			800,000
Loan capital: 400,000 Sh.1 10% debentures			400,000
			1,800,000

Additional information:

1. An analysis of the industry in which the company operates reveals the following

   industrial averages:

   Current ratio 1.5:1

   Quick ratio 0.8:1

2. The purchases for the year were Sh.2,160,000 while the cost of sales was Sh.3,000,000.

3. The market price of the company's shares as at 30 June 2023 was Sh.5.

Required:

(a) Compute the following ratios for Ushindi Limited:

(i) Return on capital employed **(2 Marks)**

(ii) Price earnings ratio **(2 Marks)**

(iii) Current ratio **(2 Marks)**

(a) Compare the company's liquidity performance with that of the industry **(3 Marks)**

QUESTION FOUR

(a) Examine two methods of handling risks in capital budgeting. **(4 Marks)**

(b) Company A is considering investing in a project which has a three-year life. The project would involve an initial investment of Sh.20 million. The finance manager has come up with expected probabilities for various possible economic conditions as follows:

Year	**Economic Conditions**	**Sh.'000'.Net cash flows**	**Probability**
0		(20,000)	1.0
1	High growth	10000	0.2
	Average growth	6000	0.7
	No growth	2000	0.1
2	High growth	12000	0.3
	Average growth	8000	0.5
	No growth	4000	0.2
3	High growth	16000	0.4
	Average growth	12000	0.3
	No growth	6000	0.3

Required:

Assuming a discount rate of 15% should company A invest in the project? **(11 Marks)**