

The
Management
University
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UNDERGRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF BACHELOR OF ARTS IN DEVELOPMENT STUDIES

PMT 404 : PROJECT FINANCING

DATE: 3RD AUGUST 2023

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 **SIX (6)** questions.
4. Question **ONE** is compulsory.
5. Answer any other **THREE** questions.
6. Question **ONE** carries **25 MARKS** and the rest carry **15 MARKS** each.
7. Write all your answers in the Examination answer booklet provided.

QUESTION ONE

- a) Identify the main users of financial statements and for each user state the kind of information they would be interested in. (10 marks.)
- b) The Chuma Ngumu Company needs to finance a seasonal rise in inventories of Sh.4 million. The funds are needed for six months. The company is considering using the following possibilities to finance the inventories:
- i) A warehouse loan from a finance company. The terms are 18 per cent annualized with an 80% advance against the value of the inventory. The warehousing costs are Sh.350,000 for the six-month period. The residual financing requirement which is Sh.4 million less the amount advanced will need to be financed by forgoing cash discounts on its payables. Standard terms are 2/10 net 30; however the company feels it can postpone payment until the fortieth day without adverse effect.
 - ii) A floating lien arrangement from the supplier of the inventory at an effective interest rate of 24 per cent. The supplier will advance the full value of the inventory.
 - iii) A bank loan from the company's bank for Sh.4 million. The bank can lend at the rate of 22%. In addition, a 10% compensating balance will be required which otherwise would not be maintained by the company.

Required:

Evaluate the cheapest option for the company?

(15 marks)

QUESTION TWO

- a) Define marginal costing and state its limitations. (5 marks)
- b) Matibabu Pharmacia Ltd. recently carried out clinical trials on a new drug which was developed to reduce the effects of diabetes. The research and development costs incurred on the drug amount to Sh.160 million. In order to evaluate the market potential of the drug, an independent research firm conducted a market research at a cost of Sh.15 million. The independent researchers submitted a report indicating that the drug is likely to have a useful life of 4 years (before new advanced drugs are introduced into the market). It is projected that in the year the drug is launched it could be sold to authorised drug stores (chemists and hospitals) at Sh.20 per 500mg capsule. After the first year, the price is expected to increase by 20% per annum. For

each of the four years of the drug's life, the sales have been estimated stochastically as shown below: Number of Capsules sold Probability 11 million 0.3 14 million 0.6 16 million 0.1 If the company decides to launch the new drug, it is possible for production to commence immediately. The equipment required to produce the drug is already owned by the company and originally cost Sh.150 million. At the end of the drug life, the equipment could be sold for Sh.35 million. If the company decides against the launch of the new drug, the equipment will be sold immediately for Sh.85 million as it will be of no further use to the company. The new drug requires two hours of direct labour for each 500 mg capsule produced. The cost of labour for the new drug is Sh.4 per hour. New workers will have to be recruited to produce the new drug. At the end of the life, the workers are unlikely to be offered further employment with the company and redundancy costs of Sh.10 million are expected. The cost of ingredients for the new drug is Sh.6 per 500mg capsule. Additional overheads arising from the production of the drug are expected to be Sh.15 million per annum. Additional work capital of Sh.2 million will be required during the drug's 4-year life.

The drug has attracted interest of the company's main competitors and if the company decides not to produce the drug, it could sell the patent right to Welo Kam (K) Ltd., its competitor, at Sh.125 million. The cost of capital is estimated to be 12%.

Required: The expected Net Present Value of the new drug. (10 marks)

QUESTION THREE

- a) Discuss five limitation of breakeven analysis. (5 marks)
- b) Discuss the advantages and limitation of zero base budgeting (6 marks)
- c) Discuss four importance of using variance analysis as a tool of project management. (4 marks)

QUESTION FOUR

- a) The financial crisis of 2008 onwards brought about renewed interest in PPP in both developed and developing countries which has let to countries to move away from the traditional way of financing capital intensive projects to Public Private Partnership(PPP). Critique the advantages and limitation of using Public Private Partnership in financing development project. (10 marks)
- b) Examine five qualities of a good tax system. (5 Marks)

QUESTION FIVE

Ridges Company Ltd. is the process of preparing its capital budget for the financial year ending 30 June 2005. The company's capital structure as at 1 July 2004 and which the management considers as optimal is presented below:

	Sh.Million
Ordinary share capital(sh. 20 par)	100
Preference share capital(sh. 10 par)	160
Share Premium	150
Retain Earnings	550
Long term debt	640

The following additional information is available: 1.

- i) The company can borrow a Sh.200 million long to on loan at a pre-tax cost 13. Any additional debt can be obtained at a pre-tax cost of 16%.
- ii) The company can raise Sh.400 million through a bond issue. Each bond will have a face value of Sh.1,000 but will be issued at Sh.687. The coupon rate on the bonds will be 10% with maturity period of twenty years.
- iii) Preferred stock can be-issued at a pre-tax cost of 16.5%.
- iv) The company expects to generate Sh.700 million in net income before tax for the year ending 30 June 2005
- v) The average annual growth rate in dividends is 5.5% and this rate is expected to continue into the foreseeable future. The company expects to

pay an ordinary dividend per share of Sh.10 for the year ending 30 June 2005.

- vi) The following investment proposals will be available to the company in the year ending 30 June 2005

Project	Outlay(sh.million	IRR
A	700	17%
B	650	16%
C	500	15%
D	400	14.2%
E	120	13%
F	80	10.9%

- vii) Assume a corporation tax rate of 30%

Required:

- a) Determine the cost of capital for each of the following sources of finance:
- Long-term loan (2 marks)
 - Bonds (2 marks)
 - Additional Debt (2 marks)
 - Preference share capital (2 marks)
 - Retained earnings (2 marks)
- b) Define sensitivity analysis and briefly explain the importance with specific reference to investment appraisal under uncertainty. (5 marks)

QUESTION SIX

- a) Securitisation may be the wave for the future, as it appears to be a more efficient mechanism for bringing borrowers and investors together than traditional financing through intermediaries (Fabozzi and Modigliani).

Required:

- Explain the term "securitisation". (4 marks)

- ii. Discuss the benefits that may accrue to a company that uses securitisation in preference to traditional financing through intermediaries. (6 marks)
- b) Distinguish between Euronotes and Eurobonds. (5 marks)