UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT AND FINANCE

Bachelor of Business Administration (Level II-Semester VII) Examination

July- 2017

FIN 2208 – International Financial Management

Two (02) Hours

Answer all Four (04) questions.

Use of calculators is permitted.

1.

i. "International Financial Management (IFM) has a wider scope than Domestic Corporate Finance (DCF) and it is designed to cope with greater range of complexities than the latter". Do you agree with this statement? Give reasons. (5 Marks)

ii. Differentiate between 'Currency Arbitrage' and 'Currency Speculation' in foreign exchange market. (4 Marks)

iii. A recent shift in the interest rate differential between Sri Lanka and Country A had a large effect on the value of LKR. However, the same shift in the interest rate differential between Sri Lanka and Country B had no effect on the value of LKR. Explain why the effects may vary. (4 Marks)

iv. Between 1980 and 1995, the Yen/Dollar exchange rate moved from ¥216.63/$ to ¥93.96/$. During this same 15 year period, the consumer price index (CPI) in Japan rose from 91.0 to 121.2 and the US CPI rose from 87.3 to 149.7.If Purchasing Power Parity (PPP) had held over this period, what would the ¥/$ exchange rate have been in 1995? (4 Marks)

v. Blue Demon Corporation has USD 150,000 to invest for one year. Considering the data given below, would you advice Blue Demon Corporation to engage in covered interest arbitrage? Show calculations. (8 Marks)

	Bid Quote	Ask Quote
Euro Spot	$ 1.12	$ 1.13
Euro 1 year Forward	$ 1.12	$ 1.13
	Deposit Rate	Loan Rate
Interest rate on Dollars	5.5%	7.5%
Interest rate on Euros	7.0%	9.5%

(Total 25 Marks)

2.

i. Explain how capital markets exert corporate control in international business environment with examples. (2 Marks)

ii. ABC is a multinational company which has head office in USA. It has operations in different countries of the world. ABC is considering a project in East European Country (EEC). Standard deviations of USA and EEC are 55.5% and 84.7% respectively. Correlation between USA and EEC markets is 0.44. ABC is going to raise finance from EEC market itself by 40% of equity and 60% of debt. The annualized risk free rate in EEC is 10% and corporate tax rate in EEC is 40%.EEC stock market return is 18% and before tax cost of debt is 13%. Calculate the weighted average cost of capital of EEC project. (10 Marks)

iii. DEF is a US based firm and has a substantial business operation in Japan. Expected return and standard deviation of returns in USA are 13% and 10.5% respectively. Expected return and standard deviation of returns in Japan are 11% and 8% respectively. Correlation between USA and Japan markets is 0.58. Business in USA from the total DEF business portfolio can be considered as 60% while business in Japan can be considered as 40%.

a. Calculate the expected return of DEF business portfolio. (6 Marks)
b. Calculate the standard deviation of DEF business portfolio. (7 Marks)

(Total 25 Marks)

3.

i. Explain how sovereign wealth funds can be used to overcome the economic phenomenon known as 'Dutch disease'. (3 Marks)

ii. PQR Group is an Indian conglomerate which has business in three other South Asian countries namely Sri Lanka, Pakistan and Bangladesh. PQR's trading currency within the group is Indian Rupees (INR). Indian head quarters (HQ) owe INR 30,000 to Sri Lankan subsidiary and Sri Lankan subsidiary owes INR 40,000 to Indian HQ. Further Indian HQ owes INR 50,000 to Pakistan subsidiary and INR 60,000 to Bangladesh subsidiary. Pakistan and Bangladesh subsidiaries owe INR 75,000 and INR 35,000 to Indian HQ respectively. Sri Lankan subsidiary owe INR 45,000 and INR 55,000 to Pakistan and Bangladesh subsidiaries. Pakistan and Bangladesh subsidiaries owe INR 25,000 and INR 80,000 to Sri Lankan subsidiary. Pakistan subsidiary owes INR 95,000 to Bangladesh subsidiary and Bangladesh subsidiary owes INR 15,000 to Pakistan subsidiary. Show the bilateral netting between four companies using a table and a diagram. (10 Marks)

iii. KLM is a Norwegian company which is considering an oil drilling project in North Sea. Cost of the estimated project is USD 1 million. It is estimated that there are oil at the site equal to 100,000 oil barrels. Variable cost of oil drilling per barrel is USD 50 per barrel. There are three possible oil prices in the next year. They are USD 45 per barrel with 0.4 probability, USD 55 per barrel with 0.3 probability and USD 65 per barrel with 0.3 probability. Required rate of return for this project is 12%. Show the decision using a tree diagram and compute the net present value (NPV) of the project. (12 Marks)

(Total 25 Marks)

4.

Germany's car manufacturer XYZ is considering in setting up a factory in a South Asian country to produce a sensor which will be used in their luxury car production. Currency of the South Asian country is SAC. Initial investment on setting up the factory is SAC 100 million which will be depreciated over 10 years with zero salvage value. Economic consultant of XYZ forecasted anticipating inflation rates for Germany and South Asian country as follows. Further it is assumed that purchasing power parity holds with no lag.

Year	**1**	**2**	**3**	**4**	**5**	**6**
Inflation rate in South Asian Country	5%	6%	7%	8%	9%	10%
Inflation rate in Germany	4%	5%	6%	7%	8%	9%

Current spot rate between two countries are SAC 50 = Euro 1 (Euro 0.02 = SAC 1). Price of the one sensor is SAC 10,000 and variable cost is SAC 5,000 per unit for first year. Price is expected to increase by 20% on year by year and variable cost is expected to increase by15% on year by year. Annual production of sensors is 12,000 units per annum and it will be increased by 10% per year. Annual overhead expense will be SAC 40 million in first year and it will be increased by 2% every year. Initial working capital requirement will be SAC 10 million and it will be 20% of revenue after commencement of the production. 6^{th} year cash flow will be regarded as a perpetuity for the purpose of terminal value calculation and cash flows are assumed to be grown at 5% from 5^{th} year to 6^{th} year. Corporate tax rate in the South Asian country is 25% and no loss can be carried forward. Required rate of the return for the project is 20%. Consider home country as Germany and indicate exchange rate with five decimal points in answers.

i. Calculate the net present value (NPV) for first five years. (15 Marks)
ii. Calculate the present value of terminal value after first five years. (7 Marks)
iii. What is your decision regarding the project considering only first five years NPV figure? (3 Marks)

(Total 25 Marks)

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