UNIVERSITY OF COLOMBO, SRI LANKA

FACULTY OF MANAGEMENT & FINANCE

Bachelor of Business Administration in Finance (Level II – Semester VII)
Examination – July, 2016

FIN 2200 – Strategic Finance

Two (02) Hours

Answer All Questions

01.

i. Why do firms borrow capital that has to be repaid rather than finance a firm with 100% equity?

(04 marks)

ii. What is the difference between Unsystematic risk and Systematic Risk?

(03 marks)

iii. When calculating the value of a company, what is the number of year cash flow to be taken for discounting purpose?

(03 marks)

iv. Nirma has a profit margin of 13.6% which is better than its competitor HLL'S 9.8%, Advertising to sales ratio is 2.5%. The company is expected to retain the same profit margin ratio for the fiscal year 2007. Based upon this figure the company wants to design the strategies for the future. Discuss the importance of finance and accounting in strategy formulations.

(05 marks)

v. In the context of the present business environment, risk management has become a critical activity for most of the firms. In the light of the above, discuss the different approaches to managing risks?

(05 marks)

(Total 20 Marks)

02.

Suppose you are hired as a consultant for Tail ways, Inc.' just after recapitalization that increased the firm's debt–to–assets ratio to 80%. The firm has the opportunity to take on a risk- free project yielding 10%, which you must analyze. You note that the risk-free rate is 8% and apply what you learned about taking positive net present value projects; that is, accept those projects that generate expected returns that exceed the appropriate risk-adjusted discount rate of the project. You recommend that Tail Ways accept the project. Unfortunately, your client is not impressed with your recommendation, because Tail ways is highly leveraged and is in risk of default, its borrowing rate is 4% greater than the risk-free rate after reviewing your recommendation, the company CEO has asked you to explain how this "positive net present value project" can make him money when he is forced to borrow at 12 % to fund a project yielding 10%. You wonder how you bungled an assignment as simple as evaluating a risk-free project. What have you done wrong?

(10 Marks)

03.

UGC Pension Plan (UGCPP) is the pension fund of a reputed organization in Sri Lanka. UGCPP is fully funded with 8 billion Rs. in assets and has the following investment policy objectives:

- Earn a 10.3% annual portfolio return.
- Have a maximum Roy's safety-first ratio with a minimum return threshold of 8%.
- Maintain a cash balance sufficient to meet liquidity requirements.
- Maintain a maximum of 10% of assets in a passively managed local equities sub-portfolio.

UGCPP expects to pay Rs. 320 million in pension benefits this year.

At an investment committee meeting regarding possible changes to UGCPP's strategic asset allocation policy, the committee reviews five alternative portfolio allocations that meet UGCPP's return objectives. These alternatives are shown in Exhibit 1.

Exhibit 1

	UGCPP Alternative Portfolio Allocations (%)				
Asset Class	**Portfolio Allocations**				
	A	B	C	D	E
Cash equivalents	3	5	6	5	6
Local equities	10	12	8	7	9
Global bonds	40	40	47	45	41
Global equities	47	43	39	43	44
Total	**100**	**100**	**100**	**100**	**100**
Portfolio Measures					
Expected total annual return	11.26	11.19	10.44	10.60	10.87
Expected standard deviation	14.90	14.82	13.93	14.15	14.52

Determine the most appropriate portfolio for UGCPP. State, for each portfolio not selected one reason why it is not the most appropriate.

(20 Marks)

04.

CFO's must have a thorough understanding of the various risks their organization face. A focus on financial risks alone is incorrect. Indeed, financial risks are the result of a company's strategic and operational decisions. A smart CFO must have a thorough understanding of the company's strategy and its implications. Only then will the CFO be able to come to grips with the risks faced by the company and implement ERM effectively. Enterprise risk management (ERM) is all about the identification and assessment of the risks of the company as a whole and formulation and implementation of a companywide strategy to manage them. At the outset, CFO's must appreciate that ERM combines the best of three different but complementary approaches. The first is to modify the company's operations suitably. The second is to create an all-purpose cushion by reducing debt in the capital structure. The third is to use insurance or financial instruments like derivatives to transfer the risk, at a price, to a third party. The CFO must weigh the difference options before implementing a risk mitigation strategy. This calls for a strategic rather than a tactical or transaction oriented approach towards risk management. CFO's must also appreciate that managing risk in an integrated way is always better than doing so in a piece meal fashion. The CFO must consider various factors before choosing between a financial solution, revolving around derivatives or insurance and an organizational solution that calls for a major revamp of operations. Strategic risks invariably need organizational solutions. Such risks are built into the very nature of the business. But, in many other solutions, financial solutions such as derivatives or insurance may be more efficient than organizational solutions. One way to resolve this dilemma is to estimate the amount of capital investment to be made to deal with a risk. This can be compared with the costs involved in transferring the risks such as insurance premium or option premium. Financial solutions are often useful when enough data is available to analyse, model and evaluate the event. If this is not the case, operations may have to be reconfigured suitably.

i. What are the steps required for the proper implementation of ERM within an organization so that the CFO's can perform their role efficient?

(30 marks)

ii. Comment on hybrid financial instruments that can be used in ERM.

(10 marks)

iii. Comment on some of the best practices followed by the CFO's.

(10 marks)

(Total 50 Marks)

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