KASNEB

CIFA PART III SECTION 6

INTERNATIONAL FINANCE

PILOT PAPER

September 2015. **Time Allowed: 3 hours.**

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

(a) A Kenyan company has agreed to sell goods to an importer in Zedland at an invoiced price of Z 150,000. Zed (Z) is the currency of Zedland. Of this amount, Z 60,000 will be payable on shipment, Z 45,000 one month after shipment and Z 45,000 three months after shipment.

The quoted foreign exchange rates Z per Kenya shilling (KSh.) at the date of shipment are as follows:

Spot	1.690	1.692
One month	1.687	1.690
Three months	1.680	1.684

The company decides to enter into appropriate forward exchange contracts through a bank in order to hedge these transactions.

Required:

(i) State two advantages of hedging as provided above. (2 marks)

(ii) Calculate the amount in Kenya shillings that the company would receive. (3 marks)

(iii) Comment with hindsight on the wisdom of hedging in this instance, assuming that the spot rates at the dates of receipt of the two instalments of Z 45,000 were as follows:

First instalment	1.69	1.69
Second instalment	1.700	1.704

(3 marks)

(b) Large companies with significant borrowings overseas often use interest rate swaps and currency swaps.

Required:

Explain how interest rates swaps may be used in the above context. (12 marks)

(Total: 20 marks)

QUESTION TWO

Gladwell is an international pharmaceutical group. It recently carried out clinical trials on a new drug which was 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 researcher 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% p.a.

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 at an original cost of 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 500mg 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 drug's 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 working capital of Sh.2 million will be required at the start of the production of the drug.

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 Drug House Ltd., its main competitor at Sh.125 million. The cost of capital is estimated to be 12%.

Required:

(a) The expected net present value of the new drug. (16 marks)

(b) State with reasons whether the company should launch the new drug. (2 marks)

(c) Discuss one strength and one weakness of the expected net present value approach for making investment decisions. (2 marks)

(Total: 20 marks)

QUESTION THREE

The government of many less developed countries have experienced problems in recent years as their debt levels have risen leading to what has been called a "global debt crisis".

Required:

(a) Explain briefly why these problems amount to a crisis. (6 marks)

(b) Discuss the approaches that have been used to overcome the problems. (8 marks)

(c) Outline the benefits to multinational business enterprises of resolving the current global debt problems. (6 marks)

(Total: 20 marks)

QUESTION FOUR

(a) In the recent past, your government has been aggressively wooing multinational companies to come and invest their resources in your country.

Required:

Analyse the key decision areas that a financial analyst would have to advise a company that is considering making direct investments in your country and discuss the risks involved. (10 marks)

(b) Your country's economy has been performing poorly in the recent past and many companies have retrenched workers while others have closed their operations. Many skilled people are having to start their own small enterprises.

Required:
As a consultant for small and medium sized firms, write a brief report explaining the various ways in which small and medium size enterprises can raise capital for investment. (10 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Suppose the Pound Sterling is bidding at £1.9724 in New York and the Euro at £1.3450 in Frankfurt. At the same time, London banks are offering the Pound Sterling at €1.4655.

Required:
Show the steps that an astute trader would follow to earn riskless profit through a triangular arbitrage. Assume that the trader begins in New York with £1000,000. (6 marks)

(b) Discuss four components of the current account in relation to balance of payment. (4 marks)

(c) In relation to foreign exchange rates regimes, explain:

(i) Fixed exchange rate or pegged exchange rate system. (1 mark)

(ii) Free floating exchange rate. (1 mark)

(iii) Managed floating exchange rate. (2 marks)

(d) Discuss three factors that affect the exchange rates. (6 marks)

(Total: 20 marks)

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