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| **Course:** | **Diploma In finanace management for NGOs** |
| **Admission No:** |  |
| **Course Code:** | **D008** |
| **Module:** | **Module three** |
| **Assignment:** | **three** |
| **Year:** | **2019** |
| **Month of Submission:** | **September 2019** |
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**MODULE 3 ASSIGNMENTS**

1. Why is the cost of capital the minimum acceptable rate of return on an investment?

The term cost of capital refers to the minimum rate of return which a firm or a business must earn on its investments so that the market value of the comapany’s equity shares does not fall.

Hampton, John defines it as the rate of return the firm requires from investment in order to increase the values of the firm in the market place.

The reasons why the cost capital the minimum acceptable rate of return on an investment are as follow:

* It is a basis of appraising new capital expenditure proposal.

This gives the acceptance or rejection criteria for capital expenditure projects.

* The finance manager must raise capital from different sources in a way that it optimizes the risk and cost factors.

The sources of funds which have less cost involve high risk.

Cost capital helps the managers in determining the optimal capital structure.

* It is also the basis for evaluating the financial performances of top management.
* It helps in formulating appropriate dividend policy.
* It helps the organization in developing an appropriate working capital policy.

The cost debt capital = Kd = (1-T) R

1. How is the Cost of Debt Capital ascertained? Give examples.

Where Kd = cost of long term debt.

T = Marginal Tax Rate.

R = Debenture Interest Rate.

Example If a firm has issued 10% debentures and the Tax Rate is 50%, the cost of debt capital will be = ( 1-5)10 = 5%

1. How will you calculate the Cost of Preferences Share Capital?

The formula for the cost of preference share capital is given by:

Cost of preference share capital = Dividend

Market price-issue cost.

1. The following details are available:

Equity (Expected Dividend 12%) Rs. 1000000

Tax Rate 50%

10% Preference Rs. 500000

8% Loan Rs. 1500000

You are required to calculate Weighted Average Cost of Capital?

|  |  |  |  |
| --- | --- | --- | --- |
| Source of funds | Amount | proportion | After tax cost |
| Debt | 1500,000 | 8 | 4.5 |
| Preference share | 500,000 | 10 | 9.00 |
| Equity share | 1000,000 | 12 | 11.00 |
|  | 3000,000 | 30 |  |

1. What is Net Present Value and how does it change by variation in discount rate.

Net present value refers to the prsent value of all the cash flows that occure during the entire life span of a project.

Here the out flows will have negative values while the inflows will have positive values.

Therefore if the present value of inflows is greater than outflows, we get a positive value and the reverse is likewise.

Net present value changes by variation in discount rate as follow:

The relationship between net present value and discount rate is when the rate of interest increases, the net present value gradually falls.

This means that as the rate of discount inceases, the net present value goes on diminishing.

1. Distinguish between NPV and PI. Which of these you consider better?

Net present value is a present value of all the cash flows that occure during the entire life span of a project.

Net present value is an aboslute value and therefore, is not appropriate for comparing the relative profitability between different projects.

In order to overcome this limitationof net present value, one modification in it to make a relative measurement and this is profitability index (PI).

P.I = present value of inflows

Present value of outflows.

Profitability Index is considered better because it is appropriate for comparing the relative profitability between different projects.

1. What are the limitations of using the NPV and IRR methods in practice? Give your

assessment.

The limitations of using both net present value and Internal Rate of Return are:

Limitations of net present value:

It gives the aboslute value and therefore, is not easy to especially when they are of different sizes.

Many a times, it is not possible to know in advance the rate of interest at which discounting is to be done.

Similarly, a given net present value may not be appropriate if the rate of interest has changed.

It may lead to wrong decision making especially when limited funds are available and we have to choose between the different options.

Limitations of Internal Rate of return.

The biggest problem with Internal Rate of Return is that it is not uniquely defined and we may get more than one IRR in some cases.

Another problem in using IRR is that it does not distinguish between lending and borrow.

Using net present value and Internal Rate of Return may again create problems when the patterns of each cash flow are different.

A comparsion between NPV, PI and IRR shows that NPV is the best capital budgeting techique because of its conceptual charity and methodology of calculation.

It is even better than PI in some respects.

1. What purpose do capital markets serve?

The term capital markets are markets that facilitate the flow of long term funds.

The main participants in these markets are households and businesses including those that are in finanace and goverments.

The participants that provide funds are called surplus units and those that obtain funds are called deficit units.

The purpose that the capital markets serve is:

Capital markets serve as an important source for productive use of an economy’s

savings.

It provides incentives to savings and facilitates capital formation by offering sustainable rates of interest as the price of capital.

It provides an avenue for investors’ particularl the household sector to invest in financial assets that are more productive rather than in physical assets.

It facilitates an increase in production and particularl in the economy and thus enhances the economic welfare of the society.

It is an important link between those who save and those who aspire to invest.

Financial markets facilitate the flow of funds from surplus units to deficit units.

The markets that facilitate short term funds are known as money markets while those that facilitate the flow of long term funds are known as capital markets.

9. What are the factors that would go into deciding whether a company should resort to debt

or equity for financing its requirement of long-term funds?

The factors that would go into deciding wether a company should resort to debt or equity for financing its requirement of long term funds are:

Long term goals; as the owner of a new business, it will be critical for you to think about what you actually hope to achieve in the long run.

What is the purpose of starting your business, where do you hope for your business to be in ten

years? By ansewering these questions, it will be easier for you to decide how financially your business entrenched.

Available interest rates; naturally the opportunity cost of choosing equity over debt finance will

largely determined by how much you will actually need to pay to borrow money.

If your business has access to low interest rates or specialty loans, the total cost of borrowing

will be relatively lower.In order to make sure that you are getting competitive quotes fro the

potential lenders, it will be a good idea to compare multiple options before making any financial decisions.

The need for control; by serrendering partial ownership of your business you are to a certain extent giving up control.

In order to make sure they can still outvote all other stakeholders, many business owners will

maintain 51 percent ownership of the business while selling the remaining 49 percent. If having

total significant control of your business is something that is important to you, be sure to limit the amount equity you end up distributing.

Borrowing requirements; there many diferent things lenders will look at when deciding wether to

issue a loan. In addition to a general financial background check, lenders will also want to see some hard numbers on papers.

Current business structure; another variable that will impact the opportunity cost borrowing or

issuing equity is your business structure. If your business is already formally structured as

partnership for example, then this may complicate process of selling equity.

Future repayment terms; while many business loans are simple, float loans with a fixed interest

rate, there are many loans with repayment terms that are notably more complicated.

For example, some loans will not require any repayment for servral years down the loan.

Access to equity markets; If you do hope to finance your business via equity, it will be crucial

that you have access to people who are actually interested in buying. Contrary to what some

Entreprenuers initially assume there is not a readily a vailable cousel of venture capitalist ready

to give funds a new business without scrutiny.

1. Discuss the role of an underwriter in managing an IPO.

The term an underwriter is any party that evaluates, and assumes another party’s risk for a fee.

The fee is often a commision, premium, spread or interest.

The role of an underwriter in managing an IPO (Initial public offering) is below:

Underwriter guarantees success of an issue by pricing the new issue using their

pricing skills,by their access to a network of investors to whom they can distribute the

issue and then skills for managing and laying off risk by providing guarantee.

Underwriter helps company to issue new shares by extending their certification which is more acceptal to public and regulatory authority.

Since they go to the market frequently, they require protecting their reputation.

They also buy the shares at discounted issue prices and issue the risk of selling them later to ivestors at higher issue prices.

They underwrter to an initial public offering typically undertakes an analysis of the company the estimates the price range for stock.

The under appraoches clients which are non binding orders for stock at different prices.

11. Why is a stock exchange an important institution of the capital markets?

The reasons why a stock exchanges an important institution of the capital markets are:

* Effective mobolization of savings; stock exchange provides organized markets an individual as well as insttitutional investors.

They regulate the trading transactions with proper rules and regulations in order to ensure investors protection.

* Promoting capital formation; the funds mobilized through capital markets are provided to industries engaaged in the production of various goods and services useful for the society.

This leads to capital formation and development of national assets.

* Wider avenues of investment; stock exchange provides a wider avenues for investment to people and organization with investible surplus.
* Liquidity of investment; stock exchange provicdes liquidity of investment to the investors.

Investors can sell out any of their investments in securities at any time during trading days and trading hours on stock exchanges.

* Investment priorities; stock exchange facilitates the investors to decide his investment priorities by providing him the basket of different kinds of securities of different industries and companies.
* Investment safety; stock exchanges through their bylaws, securities and exchange Board of india guidelines, transparent procedures try to provide safety to investment in industrial securities.
* Financial resources public for public and private sectors; stock exchanges make available the financial resources available to industries in public and private sectors through kinds of securities.
* Wide marketability to securities; online price quoting system and omline buying and selling facility have changed the nature and working of stock exchanges.

Formerly, the dealing on stock exchanges were restricted to it head quarters but now can access through internet online.

* Funds for development purpose; stock exchanges enable the government to mobilize funds for public utilities and public undertakings which take up developmental activities like power projects, shipping, railway etc.
* Barometer of national economy; stock exchange is taken as barometer of the economy of a country. Each economy is economically mobilized by its most significant stock exchange.