THE UNIVERSITY OF THE WEST INDIES
CAVE HILL

EXAMINATIONS OF JULY 2010.

CODE AND NAME OF COURSE: MGMT3053 - INTERNATIONAL FINANCIAL MANAGEMENT

DATE AND TIME: **DURATION: 2 HOURS**

INSTRUCTIONS TO CANDIDATES: This paper has 8 pages and 23 questions.

Section one is compulsory and is worth 20 marks. Section two has three questions from which candidates must answer any two questions. Each question is worth 25 marks.

SECTION 1

1. Which of the following theories suggest that firms aim to penetrate new markets over time?

   A) theory of comparative advantage and imperfect markets theory
   B) product cycle theory and imperfect markets theory
   C) theory of comparative advantage only
   D) product cycle theory only

2. Which of the following statements regarding corporate governance is *least likely* to be correct? The agency problem can be reduced if:

   A) managers are compensated three times more than other staff members.
   B) the Parent company clearly communicates the goals of each subsidiary.
   C) managers are compensated at higher rates for achieving MNC goals.
   D) mangers are provided with share option plans.

3. Which of the following *best describes* the reason why a weak home currency may not be a perfect solution to correct a balance of trade deficit?

   A) it reduces the prices of imports paid by local companies.
   B) it increases the prices of exports by local companies.
   C) foreign companies may reduce the prices of their products to stay competitive.
   D) it prevents international trade transactions from being prearranged.

4. Assume the Canadian dollar is equal to $.82 and the Peruvian Sol is equal to $.39. The value of the Peruvian Sol in Canadian dollars is *approximately*:

   A) 2.1026 Canadian dollars.
   B) 1.2100 Canadian dollars.
   C) 0.3198 Canadian dollars.
   D) 0.4756 Canadian dollars.

5. King Bank's bid price for the Japanese yen is $0.5987 and its ask price is $0.61. The bid/ask percentage spread is *closest to*:

   A) 1.88%.
   B) 1.85%.
   C) -1.85%.
   D) -1.88%.

6. LIBOR can be defined as:

   A) the average inflation rate in European countries.
   B) the interest rate commonly charged for loans between banks.
   C) the maximum loan rate ceiling on loans in the international money market.
   D) the maximum interest rate offered on bonds that are issued in London.

7. When the "real" interest rate is relatively low in a given country, then the currency of that country is *typically* expected to be:

   A) weak, since the country's quoted interest rate would be high relative to the inflation rate.
   B) strong, since the country's quoted interest rate would be low relative to the inflation rate.
   C) strong, since the country's quoted interest rate would be high relative to the inflation rate.
   D) weak, since the country's quoted interest rate would be low relative to the inflation rate.

8. If U.S. inflation suddenly **increased** while European inflation stayed the same, there would *most likely* be:

   A) an increased U.S. demand for euros and a decreased supply of euros for sale
   B) an increased U.S. demand for euros and an increased supply of euros for sale.
   C) a decreased U.S. demand for euros and an increased supply of euros for sale.
   D) a decreased U.S. demand for euros and a decreased supply of euros for sale.

TURN OVER

9. The equilibrium exchange rate of pounds is $1.70. At an exchange rate of $1.72 per pound:

   A) Demand for pounds would exceed the supply of pounds for sale and there would be a shortage of pounds in the foreign exchange market.
   B) Demand for pounds would be less than the supply of pounds for sale and there would be a shortage of pounds in the foreign exchange market.
   C) Demand for pounds would exceed the supply of pounds for sale and there would be a surplus of pounds in the foreign exchange market.
   D) Demand for pounds would be less than the supply of pounds for sale and there would be a surplus of pounds in the foreign exchange market.

10. The phrase "the dollar was mixed in trading" means that:

   A) the dollar was strong in some periods and weak in other periods over the last month.
   B) the volume of trading was very high in some periods and low in other periods.
   C) the dollar strengthened against some currencies and weakened against others.
   D) the dollar was involved in some currency transactions, but not others.

11. The international credit market is ***most likely*** interested in what type of financing?

   A) short-term financing (less than one year) and medium-term financing
   B) medium-term financing and long-term financing
   C) long-term financing and short-term financing
   D) long-term financing only

12. Bobsled Inc. is a U.S.-based MNC that frequently imports raw materials from Canada. Bobsled is typically invoiced for these goods in Canadian dollars and is concerned that the Canadian dollar will appreciate in the near future. Which of the following is ***not*** an appropriate hedging technique under these circumstances?

   A) purchase Canadian dollars forward.
   B) purchase Canadian dollar futures contracts.
   C) purchase Canadian dollar put options.
   D) purchase Canadian dollar call options.

13. The one-year forward rate of the British pound is quoted at $1.60, and the spot rate of the British pound is quoted at $1.63. The forward _______ is _______ percent.

   A) premium; 1.9
   B) premium; 1.8
   C) discount; 1.9
   D) discount; 1.8

TURN OVER

14. Telecom Inc. needs to invest ten million Nepalese rupees in its Nepalese subsidiary to support local operations. Telecom would like its subsidiary to repay the rupees in one year. Telecom would like to engage in a swap transaction. Thus, Telecom would:

    A) convert the dollars to rupees in the spot market today and convert rupees to dollars in one year at today's forward rate.
    B) convert the rupees to dollars in the spot market today and convert rupees to dollars in one year at today's forward rate.
    C) convert the dollars to rupees in the spot market today and convert dollars to rupees in one year at the prevailing spot rate.
    D) convert the dollars to rupees in the spot market today and convert rupees to dollars in one year at the prevailing spot rate.

15. Cooperative Inc. purchased a call option on British pounds for $.05 per unit. The strike price was $1.45 and the spot rate at the time the option was exercised was $1.46. Assume there are 50,000 units in a British pound option. Cooperative's net profit or net loss on this option is *closest* to:

    A) $2,500
    B) -$2,000
    C) -$2,500
    D) $2,000

16. Assume that the U.S. inflation rate becomes high relative to Japanese inflation. Other things being equal, the U.S demand for Japanese yen would ***most likely*** _______ and the supply of Japanese yen for sale would ***most likely*** _________.

    A) increase; decrease
    B) increase; increase
    C) decrease; increase
    D) decrease; decrease

TURN OVER

17. Assume the following information:

You have $300,000 to invest
The spot bid rate for the euro (€) is $1.08
The spot ask quote for the euro is $1.10
The 180-day forward rate (bid) of the euro is $1.08
The 180-day forward rate (ask) of the euro is $1.10
The 180-day interest rate in the U.S. is 6%
The 180-day interest rate in Europe is 8%

If you conduct covered interest arbitrage, what amount will you ***most likely*** have after 180 days?

A) $330,000.00.
B) $312,218.20.
C) $318,109.10.
D) $323,888.90.

18. Assume interest rate parity exists. The one-year nominal interest rate in Canada is 9%. The one-year nominal interest rate in England is 12%. The spot rate of England's dollar is $0.52. Today, you purchase a one-year forward contract on 5 million England dollars. How many Canadian dollars will you most likely need in one year to fulfill your forward contract?

A) $4,500,000
B) $2,529,800
C) $2,671,500
D) $78,000

19. Economic exposure refers to:

A) the exposure of a firm's ongoing international transactions to exchange rate fluctuations.
B) the exposure of a firm's local currency value to transactions between foreign exchange traders.
C) the exposure of a firm's financial statements to exchange rate fluctuations.
D) the exposure of a firm's cash flows to exchange rate fluctuations.

20. Assume zero transaction costs. If the 180-day forward rate is an accurate estimate of the spot rate 180 days from now, then the real cost of hedging receivables will be:

A) zero.
B) negative.
C) positive if the forward rate exhibits a premium, and negative if the forward rate exhibits a discount.
D) positive.

TURN OVER

SECTION 2

Question 1

Smith Co., a U.S.-based MNC, is expanding its operations. Smith Co. would like to value a target firm in Malaysia and has consulted you, the Finance Manager, to complete this valuation. You have been provided with the following information:

- Smith Co. anticipates constant revenue growth over the period. Consequently, the estimates for revenues for the next year are MYR500 million. Revenues are expected to increase by 10% over the following two years. The company has estimated that sales discounts are 2% of the level of sales.
- Cost of goods sold are expected to be 70% of revenues.
- Selling and administrative expenses are expected to be MYR30 million in each of the next three years.
- The target firm is expected to be kept for three years. After this time, Smith Co. will sell the firm for 700 million Malaysian ringgit (MYR) after deducting the amount for any taxes paid.
- The target owns machinery which has a historical cost of MYR80 million. The machinery is expected to be worth MYR5 million at the end of its useful life of 5 years. The company uses the straight line method of depreciation.
- The Malaysian tax rate on the target's earnings is expected to be 30%.
- In order to support operating activities, the target will need MYR9 million in cash annually. Any cash flows remaining after taxes, are remitted by the target to Smith Co.
- The exchange rate is currently $.22. The 3 year annualized interest rate in the United States is 8% while the 3 year annualized interest rate in Malaysia is 6%. Assume interest rate parity exists for the three year horizon and the forward rate is used to forecast exchange rates.
- Smith Co.'s required rate of return on similar projects is 13%.

Required:

As the Finance Manger, prepare a report to the Board of Management where you calculate the *net present value* of this target. **<u>Consider the below scenario in your recommendations:</u>**

TURN OVER

Question 1 (cont'd)

The government of the target company is currently in discussion regarding the implementation of a *blocked funds* policy, whereby firms would only be able to remit funds to the parent company after 3 years.

- How would this affect Smith Co.'s cash flows?
- How can the target firm increase value for Smith Co. during this time?

Please follow the report structure - Introduction, Body, Recommendations and Conclusion.

The net present value calculation is worth 20 marks and the report format including recommendations is worth 5 marks.

(25 marks)

Question 2

a) Carl Inc. has been in operation for 25 years and is a firm in its maturity phase. The firm specializes in the manufacturing and sale of computers and Purpleberry cell phones. The company's investments department is trying to determine the best way to mitigate risks.

For this question, we will assume that one-year put options on Canadian dollars are available, with an exercise price of $.63 and a premium of $.04 per unit. One-year call options on Canadian dollars are also available with an exercise price of $.60 and a premium of $.03 per unit. Assume the following money market rates:

	Canada	U.S.
Deposit rate	5%	8%
Borrowing rate	6%	9%

Carl Inc. expects to pay C$1,050,000 in one year on a loan. The one-year forward rate of the Canadian dollar is $.62. The current spot rate of the Canadian dollar on the market is $.59. Carl Inc. created a probability distribution for the future spot rate in one year as follows:

Probability	Future Spot Rate
30%	$0.58
35%	$0.60
35%	$0.65

Question 2 (cont'd)

Required:

i) Using the information provided, determine whether a money market hedge, a currency options hedge or a forward hedge would be most appropriate. **(10 marks)**

ii) Provided that the company used a money market hedge, calculate the effective exchange rate that Carl Inc. would lock in on its payables position. **(2 marks)**

iii) Compare the most appropriate hedge to an unhedged strategy, and decide whether Carl Inc. should hedge its payables position. **(3 marks)**

b) Compare and contrast transaction exposure, economic exposure and translation exposure, giving an example of each type of exposure. **(7 marks)**

c) Should an MNC attempt to hedge its translation exposure? Provide your answer to this question, with supporting arguments. **(3 marks)**

Question 3

a) List the **FIVE (5)** factors that influence exchange rates. For each factor give a clear example with adequate assumptions to demonstrate how the exchange rates can be affected. Show demand/supply graphs where applicable to demonstrate these effects. **(10 marks)**

b) Compare and contrast forward and futures contracts. **(5 marks)**

c) Compare and contrast the theories of Interest Rate parity, Purchasing Power parity, and the International Fisher effect. **(8 marks)**

d) Explain the technical technique for forecasting exchange rates. **(2 marks)**

END OF QUESTION PAPER