**EGERTON UNIVERSITY**

**Attempt Question ONE and choose TWO other questions**

1. a. Discuss the following terms used in valuation and give their limitations, citing examples from Kenya.
   * 1. Book value (4 mks)
     2. Fair/ intrinsic value (4 mks)
     3. Substitution value (4 mks)
     4. Replacement value (4 mks)
     5. Market Value (4 mks)
   1. You are contemplating buying shares of Harbin LTD. The following data on dividend payouts is availed to you.

|  |  |
| --- | --- |
| Year | Dividend per share (Ksh) |
| 2005 | 0.20 |
| 2006 | 0.25 |
| 2007 | 0.15 |
| 2008 | 0.25 |
| 2009 | 0.20 |
| 2010 | 0.30 (Latest payout) |

Given that your required rate of return is 19%, and applying the Gordon Dividend Growth Model, what is the most you would pay for a share in the company? (10 mks)

1. a. Consider a portfolio comprised of Security A and Security B, with an equal investment in each. Security A’s returns have an expected return of 3% and a standard deviation of 4%. Security B’s returns have an expected return of 5% and standard deviation of 6%. Complete the following table: (14 mks)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Correlation Coefficient**  **of Returns on Securities A and B** | **Portfolio**  **Return** | **Covariance**  **Between Returns on Securities A and B** | **Portfolio**  **Variance** | **Portfolio**  **Standard Deviation** |
| 1.00 |  |  |  |  |
| 0.50 |  |  |  |  |
| -0.50 |  |  |  |  |
| -1.00 |  |  |  |  |

b. Abel, an astute investor, buys redeemable preference shares and bonds and always holds them to maturity. He claims that because he holds these bonds to maturity, there is no risk. Is he correct? Explain, citing the risks (if any) that he assumes (6 mks)

3. a. Why is it that there is a cost to the firm for internally generated capital (Retained earnings)? (2 Mks)

b. Why does the cost of externally generated equity capital differ from the cost of internally generated equity capital? (6 mks)

c. ABC Honey, Inc. is evaluating its cost of capital under alternative financing arrangements. In consultation with investment bankers, ABC, Inc., expects to be able to issue new debt at par (Ksh. 100) with a coupon rate of 10% and to issue new preferred stock with a Ksh.4.00 per share dividend at Ksh.25 a share. The common stock of ABC is currently selling for Ksh.20.00 a share. ABC expects to pay a dividend of Ksh.2.50 per share next year. Market analysts foresee a growth in dividends in Invest stock at a rate of 5% per year. ABC does not expect its cost of debt, preferred stock or common stock, to be different under the two possible financing arrangements. ABC’s marginal tax rate is 40%. The two arrangements are:

|  |  |  |  |
| --- | --- | --- | --- |
| **Percentage of New Capital Raised** | | | |
| **FINANCING ARRANGEMENT** | **Debt** | **Preferred Stock** | **Common Stock** |
| 1 | 20% | 30% | 50% |
| 2 | 50% | 30% | 20% |
|  |  |  |  |

What is the cost of capital to ABC Honey, Inc., under each financing arrangement? (15 mks)

1. a. Explain how long-term financial planning is related to operational budgeting. (4 mks)

b. What is financial modeling and how does it assist the financial manager in planning? (4.5 mks)

c. Why is it important for a firm to analyze its comparative and competitive advantages in assessing its strategy? (7 mks)

d. Suppose a firm had the following assets at the end of a year:

Current assets 10,000

Plant assets 20,000

Total assets 30,000

And suppose the firm had sales of Ksh.100, 000. Using the percentage of sales methods and using this year as the base year, what are the predicted current assets and plant assets and total assets of the firm in the following year if sales are predicted to be Ksh. 125,000? (8 mks)

*5.a.* Briefly explain the concept of the efficient market hypothesis (EMH) and each of its three forms**—**weak, semi strong, and strong**—**and briefly discuss three reasons that have been advanced to explain the existence of market inefficiency. (15 mks)

*b.* Briefly discuss the implications of the efficient market hypothesis for investment policy as it applies to:

i. Technical analysis in the form of charting (4 mks).

ii. Fundamental analysis (4.5 mks).