**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)

*This is the value of the firm’s balance sheet. It often represents a historical rather than a measure of the current worth. Thus the net book value of a firm represents the depreciated value of assets less outstanding liabilities. From the accounting perspective, this net book value represents the amount of owners’ equity in the firm.*

*Criticism*

* *It is based on accounting conventions policies and estimates that are subject to a great deal of subjectivity.*
* *Historical balance sheet figures of which the book values are based are often very divergent from economic values. They do not reflect a firm’s earnings power. Hence book values cannot be regarded as good estimates of true investment values.*
  + 1. Fair/ intrinsic value (4 mks)

*This is the theoretical value of the asset (security) and can be defined as the present value of the expected future cash flows. It is the value as perceived by investors given the amount, timing, and riskiness of future cash flows. Given the riskiness, uncertainty of future cash flows, the investor determines an appropriate discount rate to use in computing the present (intrinsic) value of the asset. Once the investor has determined the intrinsic value of the security, it is compared with the market value. If intrinsic value is greater than market value, then the security is undervalued and vice versa.*

*Criticism*

* *Is based on historical data.*
* *Different models may provide different intrinsic values.*
  + 1. Substitution value (4 mks)

*This is the amount of money that could be paid to purchase the next available substitute for the production process. It involves determining the value of a security by looking at the value of a similar security of a competitor company in the same industry. The problem arises when the competitor in question has much higher (or lower) earnings capacity that makes comparison faulty e.g. EABL vs. Keroche.*

* *Firms do not have similar productive assets for the purpose of using one security as a substitute of another.*
* *No two firms are identical operating characteristics. Even firms in the same industry have different operating policies, management styles, different sizes, different sizes of diversification, technology, e.t.c.*

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  + 1. Replacement value (4 mks)

*Replacement value is based on the cost of replacing the existing assets. This is the amount that will be needed in order to purchase an asset with the same productive capacity like the one being replaced. However, only productive fixed assets can be replaced at a go since current assets are circulating assets.*

*Criticism*

* *Based only on a portion of the assets.*
* *Replacement value can be subjectively determined.*
  + 1. Market Value (4 mks)

*This is the observable value of an asset/ security in the market place. It the market price of a security that is influenced by market forces i.e. demand and supply. Other factors, however, do affect the market value of securities, namely economic factors, political factors, nature or quality of management, the firms earnings power (both current and expected), rumors and speculations on the part of investors, the industry in which the company operates, the investors required rate of return e.t.c.*

* 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= 8.45%

= = Ksh. 3.08

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** | **Portfolio** | **Covariance** |  | **Portfolio** |
| **of Returns on Securities A and B** | **Return** | **Between Returns on Securities A and B** | **Port Variance** | **Standard Deviation** |
| 1 | 4 | 24 | 25 | 5 |
| 0.5 | 4 | 12 | 19 | 4.36 |
| -0.5 | 4 | -12 | 7 | 2.65 |
| -1 | 4 | -24 | 1 | 1 |

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)

*Default risk, reinvestment rate risk, interest rate risk, currency risk.*

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

*Operational budgeting is done at the operations level of management and deals with the day to day running of a corporation. As such, it is short term budgeting. Operational budgets derive from the long term financial plans- there could be no short term planning without a long term plan from which the short term plans derive from. Again long term planning depends on what happens in the short term.*

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

*Financial modeling is a useful tool in looking at the array of relationships that exist in financial planning. It enables managers to examine the consequences of their decisions.*

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

*A comparative advantage is the advantage one firm has over others in terms of the cost of producing or distributing goods or services. For example, a store had for years a comparative advantage over its competitors through its vast network of warehouses and its distribution system. The store had invested in a system of regional warehouses and its own trucking system. Combined with bulk purchases and a unique customer approach (such as its “greeters”), the comparative advantages in its warehousing and distribution systems helped it grow to be a major (and very profitable) retailer in a very short span of time. However, as with most comparative advantages, it took competitors a few years to catch up and for the advantage to disappear. A competitive advantage is the advantage one firm has over another because of the structure of the markets, input and output markets, they both operate in. For example, one firm may have a competitive advantage due to barriers to other firms entering the same market. This happens in the case of governmental regulations that limit the number of firms in a market, as with banks, or in the case of governmental granted monopolies. A firm itself may create barriers to entry (although with the help of the government) that include patents and trademarks. Only by having some type of advantage can a firm invest in something and get more back in return. So first you have to figure out where your firm has a comparative or competitive advantage before you can determine your firm’s strategy.*

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)

*Current assets= 125000/100,000\*10000= 12,500.00*

*Plant assets= 125,000/100,000\*20000= 25,000.00*

*Total assets= 37500.00*

*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)

***The weak-form EMH*** *assumes that current stock prices fully reflect all security market information, including the historical sequence of prices, rates of return, trading volume data, and other market-generated information, such as odd-lot transactions, block trades, and transactions by exchange specialists. Because it assumes that current market prices already reflect all past returns and any other security market information, this hypothesis implies that past rates of return and other historical market data should have no relationship with future rates of return (that is, rates of return should be independent). Therefore, this hypothesis contends that you should gain little from using any trading rule that decides whether to buy or sell a security based on past rates of return or any other past market data (This is a vindication to the Technical analysts- Chartists).*

***The semi strong-form EMH*** *asserts that security prices adjust rapidly to the release of all public information; that is, current security prices fully reflect all public information. The semi strong hypothesis encompasses the weak-form hypothesis, because all the market information considered by the weak-form hypothesis, such as stock prices, rates of return, and trading volume, is public. Public information also includes all nonmarket information, such as earnings and dividend announcements, price-to-earnings (P/E) ratios, dividend-yield (D/P) ratios, price book value (P/BV) ratios, stock splits, news about the economy, and political news. This hypothesis implies that investors who base their decisions on any important new information after it is public should not derive above-average risk-adjusted profits from their transactions, considering the cost of trading because the security price already reflects all such new public information.*

***The strong-form EMH*** *contends that stock prices fully reflect all information from public and private sources. This means that no group of investors has monopolistic access to information relevant to the formation of prices. Therefore, this hypothesis contends that no group of investors should be able to consistently derive above-average risk-adjusted rates of return. The strong form EMH encompasses both the weak-form and the semi strong-form EMH. Further, the strong form EMH extends the assumption of efficient markets, in which prices adjust rapidly to the release of new public information, to assume perfect markets, in which all information is cost free and available to everyone at the same time.*

*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).

*The discussion should revolve around the fact that EMH does not support technical analysis since prices already incorporate all historical information. Thus historical information cannot be used to guide trading strategies since markets have no memory.*

ii. Fundamental analysis (4.5 mks).

*The argument should revolve around the fact that EMH does have room for fundamental analysis as a guide to developing trading strategies. Even when markets are efficient, mispricing does exist that makes it worthwhile to do fundamental analysis to uncover mispriced securities.*