**BUST 412:Financial management (SCHOOL BASED- AUGUST 2011)**

**Answer question 1 (Section A) and two other questions**

**SECTION A**

1. A. Suppose you want to buy a share of Swiss Farms, S.A., a dairy products company.

The recent dividend payouts by the firm are as follows.

|  |  |
| --- | --- |
| YEAR | DIVIDEND PER SHARE (KSH) |
| 2005 | 1.20 |
| 2006 | 1.25 |
| 2007 | 1.45 |
| 2008 | 1.60 |
| 2009 | 1.85 |
| 2010 (CURRENT YEAR) | 2.00 |

Your opportunity cost is 12%. What is this stock worth to you? (10 MKS)

B. Discuss the following capital budgeting techniques, highlighting their advantages and disadvantages.

* The net present value method(5 mks)
* The internal rate of return method. (5 mks)
* The payback method. (5 mks)
* The discounted payback period. (5 mks)

**SECTION B**

**2.**

* 1. ‘Profit maximization objective has been criticized on many grounds’. Discuss the criticism of the profit maximization as an objective of financial management (8.5 mks)
  2. Discuss wealth maximization as an alternative objective of a finance manager, highlighting its strengths and weaknesses. (15 mks)
     1. 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 (MCC) to ABC Honey, Inc., under each financing arrangement? (15 mks)

4a. 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: (16 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 (7.5 mks)

1. Write short notes on the following bond terminology.
   1. Coupon rate (2 mks)
   2. Notes (2 mks)
   3. Par value (2 mks)
   4. Maturity (2 mks)
   5. Indenture (6 mks)
   6. Debt ratings (6 mks)