**Business Finance (BANK 2007)**

**Assessment (Part 2)**

**Introduction**

Investors need to understand the different types of investments that are within the market place. For a sound investment, the investors should know when, how, where and the amount of capital which needs to be invested (Bocconcelli, 2017). Moreover, the investment decision is majorly reached by the relating investor and the investment advisor considering the long term and short-term decisions of the investor. In this case, the client needs an analysis of the different investments that are required within the terms of investment. Therefore, this report will advise the client on the individual investments that needs to be acted upon during the investment period.

**Characteristics of return on debt securities and return on equity security**

**Characteristics of return on debt securities**

Date issued and the price issue- debt security basically have the date that the loan was issued and accompanied but the prices that the investors bought the securities at the first time when the debt was issued.

Maturity date-this show the date that those who issue these securities to be paid and also give them a clear picture of theremaininginterests to paid. These maturitydate enables to determine t the terms that describes the debt securities(Siegel, 2018). Short term debt securities mature within a short period of time like below one year while long term matures after 3years or more

Coupon rate-it’s the interest that is paid by the issuer to the holders on the face value. This rateis paid annually until the maturity of the debt after the principal amount known as face value

Yield to maturity-its measured annually where the investors are needed to earn if the debt is held up to the maturity . yield to mature is important because it compares securities which have similar maturity dates and consider the purchasing price

**Characteristics of return on equity security**

Putable shares and callabes shares-they can be sold back the issuer incase the price of the stock falls below threshold. Putable shares have very lowe5r dividends. When the company has the better earning and a good cashflow the company have is important because the risk securities will be lower in addition the cumulative shares helps to reduce 5the dividends

Uncertainty of expected total return- this is measured by the standard deviation that base on the total amount of money that need to be returned after some period of time. Different methods are used by the analysts in calculating the expected return(Bocconcelli, 2017).

Preference shares and the common shares- on risk, preference shares have lower risk reason being dividends are fixed and they form the largest portion of all the total return that investor brings back. In addition, preference shares have high claim on the assets when it compared to common shares. Common shares in this case takes a large portion of the total that is returned comes from the price appreciation that is paid when the dividends have already been paid and 9in most cases this claim comes lastly on liquidation proceeds.

**Types of systematic risks**

Purchasing power risk- this type of risk occurs when the three is change in price of the products either the price shoots up which results to buying fewer products as there is hike of price . this means that if the investor doesn’t have a lot of money that will be able to sustain the rising p[rice of the products then he/she will fail in operating the business.

Market risk-falling markets is a risk to many companies because it affects the stock price of the companies(Hore, 2014). When there are no enough markets for the products of the company reduces as a result the company records some loss because there is no market for the goods.

Interest rate risk- interest rate affects income security that are fixed as a result its changes the market interest of the commodity because the rice is related with the interest rate

Exchange risk- companies that are doing transactions that comprises of many countries tend to be affected on the side of foreign exchange. Exports and imports from other countries are affect due to high exchange rate and sometimes low exchange rates that are experienced when transacting products across the border of other countries to your country.

**Types of unsystematic risks**

**Liquidity risk**

This type of risk concerns which questions over the amount of profit business you are operating will get or not get(Siegel, 2018). Business have the expenses and tries to get some profit that covers 5the expenses . aim of the business is to get the high profit that enables to run the company

**Credit risk**

The company uses the money they have or the loan so that they run the business operations that they have. In case the company don’t have capital to refund the loans to other firms then they would have recorded financial risk. The more the company carries out loan related obligations the risk increases respectively. There are some factors that can lead to firm vulnerable to financial risks and they include: management issues with the expenses and income, less equity financing compared to leverage financing and finally interest rate goes up on market that ca increase expenses than the profit they get from the business(Hore, 2014).

**Operational risk**

This risk implies the loss that every organization or the company expects to get when starting the business. This is due to error that may include: human error, computer technical problems and lastly following the old method processes that in case they would have used the advanced process

**Importance of market risk in capital asset pricing model in risk securities**

Eliminates unsystematic risk – market risks help to divert the possible risks that may result from the business and doesn’t increase the security expected return in business. Eliminating these risks will minimize the loss that can result in the organization. The market risk in CAPM will help to prevent these risks

Ease of use-helps with the method that is easy in calculating the possible range of the outcomes in business you are operating(Doha and Boychenko, 2017). Upon the easy calculations provided by these market risk in CAPM brings the confidence to provide the outcome at the rate that is required by the company

Systematic risk- it helps to measure the rate or tendency of return security that are responsible to move the stock ma4rket in parallel to return. These gauging of systematic risk base on the security volatility in relation to market volatility.

Investments appraisal- traders are able to know whether the stock or the company has long term profitability or its just short and the business is unable to run it anymore. One is able to know the estimated duration his or her business can run with some maximum profit. With this in mind traders can budget the future projects that depend on the profit of the company they are running now.

Risk free rate- helps the company to measure the risk that may occur. The companies that have high beta there are big chances to get risk on the expected returns.

**Discussions/ Workings**

***Assumptions in Using Dividend growth Model in Estimating Cost of equity***

The dividends are in a steady constant growth rate. The cost of equity is used in discounting the levered cashflows of the firm in the long run(Dovha and Boychenko, 2017).

The costs of equity are applied in the equity investmentswhile the WACC accounts are both in the equity and debtinvestments

***Market Value proportions of debt, Preference Shares and Ordinary Equity***

Debt;

=/10000000

= 0.3

Preference Shares

= 1000000/10000000

= 0.1

Ordinary Shares

= 6000000/ 10000000

=0.6

After tax Costs of capital for each Source of finance

After tax = (1 – 0.3) = 0.7

Debt = 0.7\*2745000

= 1,921,500

Preference

= 0.7\*100,000

= 70000

Ordinary  
= 0.7\*6,000,000

= 4,200,000

After tax Weighted Average cost of capital

WACC = 1921500 + 4200000+70000

= 6194500/10000000

= 0.62

Condition to use WACC in assessing new Projects.

WACC is used in the discounting of Cash flows with the risks in the similar overall firm projects. It is mainly used when the firm is financed through both Equity and debt.

**Recommendation;**

The client should consider investing in this project as this is a viable project with enough returns. Rom the calculations of the capital structure, the client has not levered the firm much and an increase in the interest rate would not affect the capital structure negatively(Dovha and Boychenko, 2017).

**Question 2**

Payback Period

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Year | Project X | Cumulative | Project Y | Cumulative |
| 0 | ($1,200) |  | ($1,200) |  |
| 1 | 250 | 250 | 320 | 320 |
| 2 | 290 | 540 | 500 | 820 |
| 3 | 460 | 1000 | ***450*** | ***1270*** |
| ***4*** | ***470*** | ***1470*** | 270 | 1540 |
| 5 | 510 | 1980 | 260 | 1800 |

The payback Period of Project X is in Year 4;

*Calculations;*

*Project x;*

The initial investment is recouped in the 3rd year and some months of year 4.

Amount remaining for ear 4 = 1200 – 1000 = 200

In Year 4; it paid = 470/12 = 39.2 per month

Of which the 200 was paid in = 200/ 39.2 = 5.1Months

PBP = 3 years and 5.1 Months

*Project Y;*

The amount is recouped after a period of 2 years and some Months in the third year;

The amount remaining after two years is; 1200 – 820 = 380

In the third year he used to pay an amount of; = 450/12 =37.5

Number of months to pay the 380 = 380/37.5 = 11.01 Months

**Question 3**

Prices of the Two Bonds at 7.5%

Bond P = $10,000/ (1.075) + $10,000(1.075) ^2 + $10,000(1.075) ^3 +$10,000(1.075) ^4 + 100,000(1.075) ^4

= 10,750 + 11,556 + 12,423 + 13,355 +133,547

=181631

Bond Q = $10,000/ (1.075) + $10,000(1.075)^2 + $10,000(1.075)^3 +$10,000(1.075)^4 + $10,000/ (1.075)^5 + $10,000(1.075)^6 + $10,000(1.075)^7+$10,000(1.075)^8 + 100,000(1.075)^8

= 10,750 + 11,556 + 12,423 + 13,355 + 14,356 + 15,433 + 16,590 + 17,835 +178,344

= 290,642

Prices of the two bonds at 12% interest rate

Bond P = $10,000/ (1.12) + $10,000(1.12)^2 + $10,000(1.12)^3 +$10,000(1.12)^4 + 100,000(1.12)^4

= 208, 608.98

Bond Q = $10,000/ (1.12) + $10,000(1.12)^2 + $10,000(1.12)^3 +$10,000(1.12)^4 + $10,000/ (1.12)^5 + $10,000(1.12)^6 + $10,000(1.12)^7+$10,000(1.12)^8 + 100,000(1.12)^8

= 371, 132.30

**References**

Bocconcelli, R., 2017. No Business is an Island: Making Sense of the Interactive Business World. *Journal of Business-to-Business Marketing*, 24(4), pp.311-314.

Dovha, N. and Boychenko, V., 2017. Can banking innovations lead to new financial crisis: case of Central and Eastern Europe? *Financial Markets, Institutions and Risks*, 1(2), pp.80-86.

Hore, S., 2014. Equilibrium Predictability, Term Structure of Equity Premia, and Other Return Characteristics. *Review of Finance*, 19(1), pp.423-466.

Siegel, D., 2018. ‘The closer you are the more information you get’ – interview met Professor Emanuel Marx. *Tijdschrift over Cultuur & Criminaliteit*, 7(3), pp.86-99.