MURANG'A UNIVERSITY COLLEGE

(A constituent College of Jomo Kenyatta University of Agriculture & Technology)

MAINCAMPUS

ORDINARYUNIVERSITY EXAMINATIONS

2015/2016 ACADEMIC YEAR

THIRDYEARFIRST SEMESTER EXAMINATIONS

FOR THE DEGREE

OF

BACHELOR OF COMMERCE

COURSE CODE: HBF 2404;

COURSE TITLE: CONTEMPORARY FINANCIAL MANAGEMENT

DATE: 22ND APRIL 2016 **TIME: 2 HOURS**

INSTRUCTIONS TO CANDIDATES

Question ONE (1) is compulsory

Answer ANY other TWO (2) questions

MRUC observes ZERO tolerance to examination irregularities

This Paper Consists of 5 Printed Pages. Please Turn Over.

QUESTION ONE

a) Discuss any four assumptions of Modigliani-Miller (MM) theory. (4mks)

b) Differentiate between;

(i)Call- option buyer and Put- Option Seller (2 Marks)

(ii)Forwards Contract and Futures Contract (2 Marks)

c) Explain the importance of the following terms as they relate to dividend issues:

[i] A Bird-in-hand (2 marks)

[ii]Asymmetric Information (2 marks)

[iv]Signaling theorem (2 marks)

d) Company ABC Ltd has 400,000shares currently trading at Sh.120 each in the Nairobi Securities Exchange. The expected dividend to be received in the year 2017 will be Sh.5 per share. The company intends to invest Sh.28, 000,000in an investment opportunity that is intended to boost the Shareholders'wealth. The company's current year's profit is sh.12, 000,000 and its cost of capital is 10%.

Required;

i. The share price in the year 2017 if the company;
   I. Pays dividend. (2 Marks)
   II. Does not pay dividend (2 Marks)
ii. The number of new shares to be floated if the company;
   I. Pays dividend. (5 Marks)
   II. Does not pay dividend. (5 Marks)
iii. Show that the payment of dividends does not affect the value of the firm. (2 Marks)

[Total: 30 marks]

QUESTION TWO

a) The following data relate to the shares in company PQR Ltd. as compared to the general performance of shares in the Securities Market;
$\sigma_s = 14\%$ $R_f = 11\%$ $R_m = 20\%$ $\sigma_m = 10\%$ and $Corr._{s,m} = +0.75$

Required

i. The Beta value for the share "s" (2 Marks)

ii. Using CAPM , determine the expected return for the share "s". (2 Marks)

iii. Comment on the sensitivity of this share. (1 Mark)

iv. What advice would you give to a risk-averse investor? (1 Mark)

b) An investor has two securities, Y and Z, with the following return characteristics:

Returns (%)	Security Y Probability	Returns (%)	Security Z Probability
30%	0.10	-20%	0.05
20%	0.20	10%	0.25
10%	0.40	20%	0.30
5%	0.20	30%	0.30
-10%	0.10	40%	0.10

Required:

(i) Compute the expected returns of Y and Z (3marks)

(ii) Compute the standard deviation of the individual securities (3marks)

(iii) Compute the correlation coefficient between the two securities returns and comment. . (3marks)

(iv) Compute portfolio expected return for portfolio consisting of 75% of Y and the rest being of Z. (3marks)

(v) Compute portfolio expected standard deviation for portfolio arrangement in part (iv) . (2marks)

[Total 20marks]

QUESTION THREE

(a) Two companies "U" and "L" Ltd are operating in the same industry. They are similar in all respect except their capital structures. Firm "L" has Sh.6m of 15% debt while firm "U" is all Equity financed. Both firms have earnings before Interest and Tax(EBIT) profit of Sh.1,200,000.The Equity capitalization rate (K_e) is 10% and the corporation rate is 35%.

Required

(i) The value of each firm using the net income approach. (4 Marks)

(ii) Using the MM's model calculate the value of the levered firm. (3 Marks)

(iii) Show how an investor in the overvalued firm can increase his returns without necessarily increasing the risk. (3 Marks)

(b) (i) Given the Walter's and the Gordon's Models, discuss the circumstances under which the dividend policy is irrelevant in determining the value of a firm. (4 Marks)

(ii) PQR Ltd has provided you with the following information;

The earning per share is Sh.15, 200,000; The expected rate of return is 16% while the cost of capital is 12% and that the dividend payout policy of the company is 80%.

Required

Determine the Company's values of the share (P_o)using;

(I) Walter's Model (3 Marks)
(II) Gordon's Model (3 Marks)

(Total; 20mks)

QUESTION FOUR

(a) Describe the possible predictors that a company is an easy target. (4 Marks)

(b) Discuss the defensive tactics of a target company (4 marks)

(c) Company XYZ is in the business of options. Its put-option has the following characteristics;

Exercise price Sh.60

Premium per put Option Sh. 6

Time to the expiry of the option; 8 Months.

Required;

(i)The value of the put Option (4 Marks)

(ii)The profit/Loss assuming the following Market prices of the underlying security after six months.(Sh.0, Sh.35, Sh.40, Sh.45, Sh.50, Sh.60, Sh.70, Sh.80) . (4 Marks)

(iii)Draw a profit/Loss versus Price movement to illustrate your work in part (ii)

(4 Marks)

(Total 20 marks)