

KABARAK



UNIVERSITY

UNIVERSITY EXAMINATIONS

2009/2010 ACADEMIC YEAR

FOR THE DEGREE OF BACHELOR OF COMMERCE

COURSE CODE: BMIT 222

COURSE TITLE: BUSINESS FINANCE

STREAM: Y2S2

DAY: MONDAY

TIME: 9:00 A.M.– 12:00P.M.

DATE: 07/12/2009

Instructions

1. Attempt question ONE and any other THREE questions.
2. Question one carries 40 marks and the rest 20 marks each.
3. Show all your workings clearly.

QUESTION ONE

(a) Distinguish between each of the following sets of capital budgeting terms:

- (i) Leasing and hire purchase (4mks)
- (ii) Independent vs. mutually exclusive projects (4mks)
- (iii) Capital structure and capitalization (4mks)
- (iv) Staggered boards and multiple directorships (4mks)
- (v) Annuity vs mixed stream cash flows (4mks)

(b) Respond to the following comments:-

- (i) Profits are the same as cash flows. (2mks)
- (ii) Capital structure is the same as financial structure (2mks)
- (iii) Harry Markowitz was just another non-Kenyan (2mks)

(c) (i) Briefly explain the following methods of investment appraisal:

- (i) Profitability index (2mks)
- (ii) Net present value (3mks)

(iii) A company operating in Nakuru town is considering buying a new machine to increase its production. Two machines, being promoted by different vendors, have been identified with the following cash flows:

End of Year	Net Cash Flows(Kshs. '000)	
	Machine A	Machine B
0	25,000	5,000
1	20,000	8,000
2	15,000	10,000
3	12,000	12,000
4	10,000	15,000
5	5,000	20,000
6	3,000	30,000

The company's cost of capital is 12% p.a. Assess the suitability of the capital project using the following methods:-

- (a) Pay back period (3mks)

- (b) Net present value method (3mks)
(c) Profitability index (3mks)

(Total: 40 marks)

QUESTION TWO

- (a) Briefly explain four sources of finance available to small and medium sized enterprises (SMEs) for financing the acquisition of non-current assets. (6mks)
(b) Kabu Ltd Finance Manager is considering buying stocks X and Y being sold in Nairobi Stock

State of Economy	Probability	Stock X	Stock Y
A	0.1	-8	14
B	0.2	10	-4
C	0.4	8	6
D	0.2	5	15
E	0.1	-4	20

Required

- (i) Calculate the expected returns and risks of each stock (6mks)
(ii) Calculate the covariance and correlation coefficient between the two stocks. (4mks)
(iii) What is the expected return and risk of a portfolio with equal weights? (4mks)

(Total: 20 marks)

QUESTION THREE

- (a) (i) Distinguish between systematic risks and unsystematic risk (Illustrate with the help of a diagram) (6mks)
(ii) Explain the reason that may drive a company to raise equity finance rather than debt finance. (4mks)
(b) Janet is considering investing in a corporate bond with possible one-year returns distributed as follows:

Returns	6%	9%	11%	13%	16%
Probability	0.15	0.20	0.30	0.20	0.15

Required

- (a) Determine the expected return and standard deviation of the above security.
- (b) Suppose that Janet now wants to form a portfolio of Kshs. 1 million, with Kshs. 400,000 invested in the above bond, denoted B. If the rest of the funds are invested equally in the stocks K and C OF tow companies, determine the expected return of the portfolio given the following information:

Security	Expected Return %
K	10
C	12

(4mks)

(Total: 20 marks)

QUESTION FOUR

- (a) Explain the role of the financial manager in a modern corporate setting and environment (5mks)
- (b) Huge limited is contemplating a complete share acquisition of Tiny ltd. Huge Ltd is offering three of its shares for every two shares of Tiny Ltd. The data relating to the two companies are shown below.

	Huge Ltd	Tiny Ltd
	Sh.	Sh.
Earnings to ordinary shareholders before tax	5,200,000	2,400,000
Earnings per share (EPS)	15.00	30.00
Market Price per share	200	300

The corporate tax rate is 30%.

Required:

- (a) Highlight the advantages of growth by acquisition. (5mks)
- (b) Compute the post acquisition EPS of the two companies. (5mks)
- (c) What alternative forms of payment are available in a bid? (3mks)

- (d) Given that the growth rate of Huge Ltd is 8%, while that of Tiny Ltd is 12%, compute the combined growth rate of the two companies. (2mks)

(Total: 20 Marks)

QUESTION FIVE

- (a) Using knowledge of agency theory, discuss how to resolve the potential conflicts arising between:

(i) Shareholders and management (7¹/₂mks)

(ii) Leaders and owners (7¹/₂mks)

- (b) The concept of cost of capital is essential in many aspects of corporate management. Briefly explain any two methods that can be used in the estimation of cost of capital.

(5mks)

(Total: 20 marks)