MASENO UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

FOURTH YEAR SECOND SEMESTER EXAMINATIONS FOR THE
DEGREE OF BACHELOR OF BUSINESS ADMINISTRATION
(FINANCE OPTION) WITH INFORMATION TECHNOLOGY

CITY CAMPUS

ABA 420: CORPORATE FINANCE

Date: 24th July, 2017   Time: 5.30 – 8.30 pm

INSTRUCTIONS:

- Answer question ONE and any other THREE questions.

QUESTION ONE: (COMPULSORY)

a) Discuss why does ordinary share capital have a high cost relative to debt capital? (6 marks)

b) Explain the risk preferences giving examples that an investor may engage in. (6 marks)

c) Explain simulation analysis is limited in practical use. (3 Marks)

d) A project has the following cash flows:-

Cash flows	Probability	Cash flows	Probability
60,000	0.3	50,000	0.3
		60,000	0.5
		70,000	0.2
80,000	0.4	60,000	0.3
		80,000	0.5
		100,000	0.2
100,000	0.3	80,000	0.3
		100,000	0.5
		120,000	0.2

The projects initial cash outlay is KShs 100,000 with a cost of capital of 12%.**Required:**

Determine:

a) The projects expected monetary value (EMV). (7.5 Marks)

b) The projects Net Present Value. (7.5 Marks)

QUESTION TWO:

The risk free rate is 10% and the expected return on the market portfolio is 15%. The expected returns for 4 securities are listed below together with their expected betas

Security	Expected Return	Expected Beta
A	17.00%	1.3
B	14.50%	0.8
C	15.50%	1.1
D	18.00%	1.7

REQUIRED:

a) On the basis of these expectations, which securities are overvalued? Which are undervalued? (7.5 Marks)

b) If the risk-free rate were to rise to 12% and the expected return on the market portfolio rose to 16%, which securities would be overvalued? Which would be under-valued? (Assume the expected returns and the betas remain the same). (7.5 Marks)

c) Distinguish Security Market Line and Capital Market line. (5 Marks)

QUESTION THREE:

Sammy and Jimmy Ltd purchased a machine 5 years ago at a cost of KShs 1,000,000. It had an expected life of 10 years at the time of purchase and an expected salvage value of KShs 100,000 at the end of its useful life. It is being depreciated by a straight line.

A new machine can be purchased for KShs 1,500,000 including installations costs. Over its 5 year life, it will reduce cash operating expenses by KShs 500,000 per year. Sales are not expected to change. At the end of its useful life the machine is considered to be worthless.

The old machine can be sold today for KShs 650,000. The firm's tax rate is 35% and the appropriate discount rate is 15%.

Required:

a) Determine whether the machine should be replaced using the NPV criterion.

(16 marks)

b) What other factors should be considered before making the decision at (a) above?

(4 marks)

QUESTION FOUR:

Discuss using relevant examples and diagrams various strategies employed by option traders. (20 marks)

QUESTION FIVE:

a) Explain the factors that influence the dividend policy if a firm. (10 marks)

b) Discuss the various theories used under dividend policy. (10 marks)