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**University Examinations 2015/2016**

FIRST YEAR SECOND SEMESTER EXAMINATION FOR THE DEGREE OF

MASTER OF

BUSINESS ADMINISTRATION

**BFA 5231: CORPORATE FINANCE**

**DATE: AUGUST 2016 TIME: 3 HOURS**

**INSTRUCTIONS:** *Answer question* ***one*** *and any other* ***three***questions.

**QUESTION ONE (30 MARKS)**

1. Since agents are custodian trustees and stewards of the organization they are answerable and accountable to the owners. For successful corporate governance the role of shareholder directors and other employees must be clearly defined. The directors must be made accountable to somebody. They must be clearly aware of the fact that failure to give a good account will not go unpunished. Clearly discuss the elements of good corporate governance. (10 marks)
2. A comparative study of the records of two oil companies, A Ltd and B Ltd, in terms of their asset composition, capital structure and profitability shows that they have been very similar for the past five years. The only significant difference between the two firms is their dividend policy. A Ltd. maintains a constant dividend per share while B Ltd maintains a constant dividend pay-out ratio. Relevant data is as follows:

|  |  |
| --- | --- |
| A Ltd | B Ltd |
| Year | Earnings per share | Dividend per share | Price range in stock exchange | Earnings per share  | Dividend per share  | Price range in stock exchange  |
|  | Shs. | Shs. | Shs. | Shs. | Shs. | Shs. |
| 1996 | 1.89 | 0.45 | 16 – 18 | 2.05 | 0.35 | 11 – 15 |
| 1997 | 1.50 | 0.45 | 12 – 15 | 1.45 | 0.25 | 6 – 14 |
| 1998 | 2.00 | 0.45 | 14 – 20 | 2.07 | 0.36 | 7 – 16 |
| 1999 | 2.60 | 0.45 | 21 – 26 | 2.55 | 0.45 | 15 – 23 |
| 2000 | 3.90 | 0.45 | 26 - 40 | 4.08 | 0.69 | 21 - 44 |

**Required:**

1. For each company, determine the dividend pay-out ratio and the price earnings ratio for each of the five years. (8 marks)
2. B Ltd’s management is surprised that the shares of this company have not performed as well as A Ltd.’s in the stock exchange. What explanation would you offer for this state of affairs? (2 marks)
3. Research suggest that perhaps 20 percent of all mergers and acquisitions are successful, approximately 60 percent produce disappointing results, and the last 20 percent are clear failures. Successful acquisitions generally involve a well-conceived strategy in selecting the target, the avoidance of paying too high a premium, and employing an effective integration process. Discuss the main challenges in an optimal acquisition process. (10 marks)

**QUESTION TWO (10 MARKS)**

The following data are pertinent for companies A and B.

 ***A B***

Present Earnings Shs 20 million Shs 4 million

No of Shares 10 million 1 million

Price/earnings ratio 18 10

1. If the two companies were to merge and the exchange ratio were one share of Company A for each share of Company B, what would be the initial impact on earnings per share of the two companies? What is the market value exchange ratio? Is the merger likely to take place?
2. If the exchange ratio were two shares of Company A for each share of Company B what would happen with respect to the above?
3. If the exchange ratio were 1.5 shares of Company A for each share of Company B, what would happen?
4. What exchange ratio would you recommend? (10 marks)

**QUESTION THREE**

1. Suppose we have to ask to analyze two portfolios having the following characteristics

Portfolio Observed Return Beta Residual Variance

1 0.18 1.8 0.04

2 0.12 0.7 0.00

* The return on the market portfolio is 0.14
* The risk free rate is 0.07
* The standard deviation of the market portfolio is 0.02

Compute:

1. The Jesen Index for portfolios 1 and 2
2. The Treynor Index for portfolios 1 and 2 and the market portfolio
3. The sharp Index for portfolios 1 and 2 and the market portfolio (10 marks)

**QUESTION FOUR (10 MARKS)**

1. Discuss five factors that affect the dividend policy of a firm (5 marks)
2. Makutano limited wishes to expand its output by purchasing a new machine worth 170,000 and installation costs are estimated at 40,000/=. In the 4th year, this machine will call for an overhaul to cost 80,000/=. Its expected inflows are:

|  |  |
| --- | --- |
|  | Shs. |
| Year 1 | 60,000 |
| Year 2 | 72,650 |
| Year 3 | 35,720 |
| Year 4 | 48,510 |
| Year 5 | 91,630 |
| Year 6 | 83,715 |

This company can raise finance to purchase machine at 12% interest rate.

Compute NPV and advise management accordingly. (5 marks)

**QUESTION FIVE (10 MARKS)**

Abba investments wants to invest in securities C and D of firms in two different industries. The following information relates to the two securities.

|  |  |  |
| --- | --- | --- |
|  | C | D |
| Expected return | 14% | 12% |
| Standard deviations  | 5 | 3 |
| Beta  | 1.70 | 1.20 |
| Amount of money invested  | Shs 720,000 | Shs 480,000 |

**Required:**

1. Calculate the expected portfolio return
2. Calculate the beta of the portfolio
3. Explain what happens to the portfolio risk if the returns of the two securities are
4. Perfectly positively correlated
5. Perfectly negatively correlated (10 marks)