# MACHAKOS UNIVERSITY

**University Examinations for 2020/2021 Academic Year**

**SCHOOL OF BUSINESS AND ECONOMICS**

**DEPARTMENT OF ACCOUNTING BANKING AND FINANCE**

**THIRD YEAR FIRST SEMESTER EXAMINATION FOR**

**BACHELOR OF COMMERCE**

**BAC 308 CORPORATE FINANCE**

**DATE: 17/8/2021** **TIME: 2.00-4.00 PM**

**INSTRUCTIONS:**

**Answer question ONE and any other TWO questions**

**QUESTION ONE (30 MARKS) (COMPULSORY)**

a) Explain three theories that focus on operations of financial markets (6 marks)

b) Outline three measures that may be instituted to resolve Conflicts between shareholders and management (6 marks)

c) Consider two investments, A and B each having the following investment characteristics;

| *Investment* | *Expected Return (%)* | *Proportion* |
|---|---|---|
| A | 17 | 3/4 |
| B | 14 | 1/4 |

Compute the expected return of the portfolio (4 marks)

d) Explain five objectives of a business firm. (10 marks)

e) The CAPM is given as follows:

$R_i = R_F + [E(R_M - R_F)]ß$

Where $R_i$ is required return of security i

$R_F$ is the risk free rate of return

$E(R_M)$ is the expected market rate of return

ß is Beta.

Explain the relationship that can be observed between $ß_i$ and $E(R_i)$ from the above formula. (4 marks)

**QUESTION TWO (20 MARKS)**

a) Explain five implications of efficient market hypothesis to financial decision makers (10 marks)

b) ABC Company is considering the acquisition by shares of XYZ Company . The following information is available.

| | **ABC Company** | **XYZ Company** |
|---|---|---|
| Present earnings | Shs 10,000,000 | Shs 2,500,000 |
| Shares | 2,500,000 | 1,000,000 |
| Earnings per share | Shs 2 | Shs 1.25 |
| Price/earning ratio | 8 | 6 |
| Price of shares | Sh 32 | Sh 15 |

XYZ Company has agreed to an offer of Shs 17.5 a share to be paid in ABC Company shares.

**Required:**

Consider the effect of the acquisition to the earnings per share. (10 marks)

**QUESTION THREE (20 MARKS)**

John Manase invested 80% and 20% of his funds in companies X and Y respectively. The following probability distribution relates to expected returns from the companies under different economic states.

| Economic state | Probability | Expected Return in Percentage | |
|---|---|---|---|
| | | X | Y |
| Boom | 0.20 | 9 | 5 |
| Steady growth | 0.60 | 12 | 11 |
| Slump | 0.20 | 3 | 6 |

Calculate the:

a) Expected return from company X and Y (4marks)

b) Expected portfolio return (3 marks)

c) Standard deviation of returns from company X and Y (4 marks)

d) Covariance between returns from the two companies (3 marks)

e) Coefficient of correlation between returns of the two companies (3 marks)

f) Portfolio risk (3 marks)

**QUESTION FOUR (20 MARKS)**

a) Explain four types of mergers. (8 marks)

b) With the help of a diagram explain the efficient frontier. (7 marks)

c) Namanga ltd has an outstanding ksh. 2,000 bond ths is convertible into common stock at ksh. 100 per share. The current market price is ksh. 60 per share. Calculate the conversion value. (5 marks)

**QUESTION FIVE (20 MARKS)**

a) Explain five features of warrants. (10 marks)

b) The Arbitrage Pricing Theory (APT) is much more robust than the capital asset pricing model. Explain. (10 marks)