

AFRICAN ECONOMIC RESEARCH CONSORTIUM

Collaborative MA Programme in Economics for Anglophone Africa
(Except Nigeria)

JOINT FACILITY FOR ELECTIVES (JFE)

JULY – OCTOBER 2006

CORPORATE FINANCE AND INVESTMENT I

First Semester: Final Examination

Duration: 3 Hours

Date: Monday, August 14, 2006

INSTRUCTIONS:

1. Students are allowed to bring to the exam mathematical tables and written formulas with **no text written on them**.
 2. The **accuracy, precision and clarity** with which answers are expressed are important.
 3. Answer **ANY FOUR** of the following six questions. Each question carries **25** marks.
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Question 1

- (a) What characteristics do common stock and owner's equity have in common?
Describe **[5 Marks]**
- (b) Explain the distinctions between the two. **[5 Marks]**
- (c) By going public, privately held firms get access to alternative source of finance from the general public while allowing its owners to cash in on their success as market value will be attached to their holdings. Explain why many firms still remain privately held despite the advantages of going public. **[15 Marks]**

Question 2

- (a) Briefly explain the risk-sharing, liquidity and pricing-information services of a secondary market. **[8 Marks]**
- (b) Explain the Fisher effect **[5 Marks]**

Mr. Obwona has invested in securities that give nominal yield of 15%. According to the country's tax schedule, Mr. Obwona is in the 30% tax bracket. The rate of inflation is 9%.

- (c) Answer the following four questions based on the above information **[12 Marks]**
- (i) What will be the real return on Mr. Obwona's investment before-tax?
- (ii) Compute his after-tax real return if the country's tax code allows compensation for the effect of inflation?
- (iii) Compute the after-tax real return if there is no tax allowance for the effect of inflation?
- (iv) Calculate the 'penalty' on Mr. Obwona imposed by inflation?

Question 3

- (a) Identify the various ratios used to assess the liquidity position of a firm. **[2 Marks]**
- (b) Formulate the commonly used liquidity ratios and describe what each ratio measures, and their difference. **[4 Marks]**

Consider the following information about a hypothetical company:

Total assets = Kshs 13,396

Total liabilities = Kshs 8,456

Shareholder's equity = Kshs 4,940

Income Statements (for end Fiscal Year 2005) in Kshs

Sales	21,000
. Cost of goods sold	15,000
Gross profits	6,000
. Operating expenses	4,000
Net operating income	2,000
. Interest expenses	300
Earnings before taxes	1,700
. Taxes	300
Net income	1,400

- (c) Based on the information provided above, answer questions (i) to (iv) **[15 Marks]**

Compute the following:

- (i) Gross profit margin
 - (ii) Operating profit margin
 - (iii) Return on assets (ROA)
 - (iv) Return on equity (ROE)
 - (v) Equity multiplier
- (d) Two companies, XY and ABC, have the same returns to assets (ROA) but XY's return to equity (ROE) is larger than that of ABC. What explains the difference in their returns to equity (ROE)? **[4 Marks]**

Question 4

- (a) What is the 'intrinsic value' of a stock and what does it tell us? **[5 Marks]**

The most recent dividend paid by Fortune Comp. shares is \$4 per share. The company has adopted a new stable dividend growth policy approved by the Board. According to the policy, dividends will grow at a rate of 6 per cent per annum for the foreseeable future. The discount rate is 12 %.

Showing your work clearly:

- (b) Calculate the expected dividends per share at the end of each of the 4th and 5th years **[8 Marks]**
- (c) Compute the intrinsic value of the stocks of Fortune Comp.? **[4 Marks]**
- (d) Explain what the intrinsic value will be if the rate of growth of dividends is larger than the discount rate? **[4 Marks]**

- (e) Compute the intrinsic value of the stocks if dividends were to remain constant? **[4 Marks]**

Question 5

Modern corporate firms are characterised by dispersed ownership and effective separation of ownership and control, hence a potential principal - agent problem and associated costs.

- (a) Explain the principal-agent problem and why it arises? **[5 Marks]**
- (b) Explain the associated agency costs? **[5 Marks]**
- (c) Outline the possible mechanisms suggested in the literature to reduce the agency problem. **[6 Marks]**
- (d) What are the costs that bankruptcy may impose on managers? **[4 Marks]**
- (e) Does increasing the stake of managers in the firm provide a likely solution to the principal-agent problem? Explain **[5 Marks]**

Question 6

Does financial development affect economic growth? Discuss how? **[25 Marks]**

THE END