MUEO

MOI UNIVERSITY

OFFICE OF THE DEPUTY VICE CHANCELLOR, ACADEMIC AFFAIRS, RESEARCH & EXTENSION

UNIVERSITY EXAMINATIONS

2014/2015 ACADEMIC YEAR

FORTH YEAR END OF SEMESTER EXAMINATIONS

FOR THE DEGREE OF
BACHELOR OF BUSINESS MANAGEMENT

EXAM CODE:- **BBM 410**

COURSE TITLE:- **FINANCIAL MANAGEMENT**

DATE:- 14TH APRIL, 2015 **TIME:- 9.00A.M. – 12.00 NOON.**

INSTRUCTION TO CANDIDATES
- SEE INSIDE.

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BBM 410: FINANCIAL MANAGEMENT MAIN EXAMINATION
ANSWER QUESTION ONE AND ANY OTHER THREE QUESTIONS

QUESTION ONE

a) With appropriate examples distinguish UNIQUE RISK from SYSTEMATIC RISK and explain how the two types of risks can be managed in practice. **(6 marks)**

b) Discuss the CAPITAL ASSET PRICING MODEL (CAPM) as a financial tool for evaluating individual risky assets and risky portfolios and state at least five basic assumptions underlying this model. **(8 marks)**

c) You are given the following 5 projects a firm intends to undertake but is worry of the risky situation of the investments. Information pertaining to the assets is as follows:

PROJECT A	EXPECTED RETURN (%)
A	25
B	20
C	15
D	10
E	12

The risk free rate of return is 10% and risk premium pertaining to the projects is 5%. Advice the firm on the likely market risk of each investment and deduce the relationship between the expected return and the undiversifiable risk of each investment. **(6 marks)**

d) Describe the conceptual differences between capital asset pricing model (CAPM) and arbitrage pricing theory (APT) and give at least 3 major assumptions underlying the APT. **(5marks)**

e) Consider the following information pertaining to two assets and a two factors model.
   i. Factor 1: changes in the rate of inflation. The risk premium related to this factor is 1% for every 1% change in the rate.
   ii. Factor 2: percentage growth in real GNP. The average risk premium related to this factor is 2% for every 1% change in this rate.
   iii. The risk free rate of return is 3%. The two assets, X and Y have the following response coefficients to these factors:

   Bx1: the response of asset X to changes in the rate of inflation is 50%.
   By2: the response of asset Y to changes in the rate of inflation is 200%.
   Bx2: the response of asset X to changes in the growth rate of real GNP is 150%.
   By2: the response of asset Y to changes in the growth rate of real GNP is 175%.
   You are required to determine the expected rate of return of the two assets using APT model. Which is the riskier asset and why? **(15marks)**

QUESTION TWO

JUBILEE ALLIANCE PARTY (JAP) is focused to win the 2017 general elections and thus intends to undertake an ICT project expected to cost Ksh 100million and the expected net cash inflows for the 5 years of the project life is Ksh 50 million p.a. the sensitivity of asset returns to market returns is 2.0. The average return on the aggregate market portfolio is 20%. The risk-free rate of return is 10%. You are required to determine the viability of the project under the following scenarios:

(i) RISKY SITUATION **(5marks)**

(ii) CERTAINTY EQUIVALENT **(15marks)**

QUESTION THREE

a. Discuss the FUNCTIONS and the IMPORTANCE of working capital management. **(6marks)**

b. Explain the major determinants of the level of debtors and enumerate the 5Cs of credit and highlight the factors to consider when formulating a credible credit policy. **(10marks)**

c. Describe one cash management model that you are familiar with. **(4marks)**

QUESTION FOUR

a. Discuss THREE THEORIES that have been advanced to explain the relationship between the cost of capital, valuation of the firm and capital structure. **(10marks)**

b. You are provided with the following information regarding a hypothetical firm.

   i. Expected net operating income Ksh 100million.
   ii. 5-year loan of Ksh 500million at 6%
   iii. Cost of equity capital 10%

   What are the weighted average cost of capital (WACC) and the value of the firm under the net income approach? **(5marks)**

c. A firm has the following particulars:

   i. Expected net operating income Ksh 1,000,000
   ii. Composite cost of capital 10%
   iii. Debt to the tune of Ksh 5,000,000 at 6%

   What is the value of the firm and cost of equity capital under the Modigliani & Miller (MM) approach? **(5marks)**

QUESTION FIVE

a. Highlight the main influences to an American call option. (6marks)

b. An American option (both call and put) has the following features:

   i. TIME TO MATURITY 60days
   ii. MARKET PRICE Ksh 100
   iii. EXERCISE PRICE Ksh 80
   iv. VOLATILITY OF ASSET PRICE =40%
   v. RISK-FREE RATE OF RETURN 10%

   Determine the value of both the call and put option. **(10marks)**

c. Underscore at least 4 basic assumptions underlying valuation of options. **(4marks)**