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KIRIRI WOMENS' UNIVERSITY OF SCIENCE AND TECHNOLOGY

UNIVERSITY EXAMINATION, 2023/2024 ACADEMIC YEAR
THIRD YEAR, FIRST SEMESTER EXAMINATION
FOR THE DEGREE OF BACHELOR OF SCIENCE
(BUSINESS ADMINISTRATION)

Date: 14th April, 2023
Time: 8.30am –10.30am

KFI 302 - INVESTMENT ANALYSIS 1

INSTRUCTIONS TO CANDIDATES

ANSWER **QUESTION ONE (COMPULSORY)** AND **ANY OTHER TWO** QUESTIONS

QUESTION ONE (30 MARKS)

a) Dyer and Blair Investments Ltd. is a securities advisory firm consulted by Mr. Peters. They advised him to invest in EABL Ltd.'s shares, a highly lucrative company, which they believe will fit his investment portfolio. Dyer and Blair forecast that EABL's dividends will grow at a constant rate of 8% per year for the foreseeable future, while the latest reports indicate the firm will pay a dividend of Ksh. 18 per share. Their current market share price is Ksh. 195. Investors' minimum required rate of return in this market is 15%?
Required:
   i) In your opinion, do you think EABL's stock is over- or underpriced? (Show your workings) (3 marks)
   ii) What is the stock's intrinsic value if the company decides to pay a constant dividend per share of Ksh. 22 in perpetuity without any growth? (3 marks)
   iii) Outline the assumptions of Gordon's model as an asset pricing model. (3 marks)

b) Investor behaviour is characterised by various factors including risk tolerance. Outline the different risk attitudes in financial markets that Mr. Peter may possess. (6 marks)

c) Akai Ltd. has preference shares with a face value of Ksh. 140 and pays 6% of the price as dividends. If the required rate of return of a rational investor is 10%, what is the value of the preference share? (3 marks)

d) Using appropriate examples outline three classifications of investments that Akai Ltd. can utilise. (6 marks)

e) Using Nairobi Securities Exchange-listed firms such as EABL Ltd above as examples, highlight the anomalies that violate the concept of efficiency in capital markets around the world. (6 marks)

QUESTION TWO (20 MARKS)

a) Bonds are financial instruments used by firms to raise funds to finance their usually long-term investment projects. Describe the traits identifiable with the Kenyan bond market. (8 marks)

b) Miondoko Ltd. has 900,000 shares outstanding at the current market price of Ksh. 130 per share. The company wishes to raise Ksh. 22.5 million to finance a number of proposed projects. The shareholders have agreed to conduct a rights issue to raise these funds where the subscription prion per share has been set at Ksh. 75.

Required;

i) How many shares are required to purchase one new right? (3 marks)

ii) Determine the theoretical value of one right. (3 marks)

iii) Determine the theoretical ex-right price of the share. (3 marks)

c) In your own opinion, explain why the rate of return on a treasury bill is lower than a commercial paper, yet they both belong to the same classification of short-term investment instruments. (3 marks)

QUESTION THREE (20 MARKS)

a) Financial literacy has been highlighted as one of the key skills required by an investor. In order to make wise investment decisions, an investor is advised to follow a specified procedure used in investment analysis. Describe the steps involved in the decision making process. (10 marks)

b) Grace is an avid investor in the Kenyan bond market where she has been investing in various types of bonds over the years. She recently came across a firm issuing two bonds with different terms; Bond A has a face value of Ksh. 2,000,000, coupon rate of 12% and matures in 5 years. Bond B on the other hand has a face value of Ksh. 2,500,000, coupon rate of 10% and matures in 3 years. Showing your workings, determine the profit she stands to make from each bond and advise her on the appropriate bond to invest in considering Bond A pays its coupon annually, while Bond B pays semi-annually, and the cost of capital for both bonds is 14%. (8 marks)

c) Justify why an investor would prefer a bond whose coupon rate of return is lower than his or her minimum required rate of return. (2 marks)

QUESTION FOUR (20 MARKS)

a) The Efficient Market Hypothesis states that asset prices reflect all available information regarding that asset, and that any new information is instantaneously reflected in the price. However, for this theory to hold true, it relies on agreed upon assumptions. Discuss the assumptions of this hypothesis. (8 marks)

b) The security market line shows the relationship between risk and expected returns of various securities and help investors choose the securities to invest in. Using appropriate illustrations, discuss how an investor would identify an over-valued and under-valued using the SML. (8 marks)

c) The Capital Asset Pricing Model and the Arbitrage Pricing Model are two of the most common asset pricing models used today. Discuss some of the reasons why APT is considered superior to the CAPM. (4 marks)

QUESTION FIVE (20 MARKS)

a) Firms can raise additional equity capital through a number of ways in secondary financial markets. However, for an existing shareholder, the decision to invest in more of a firm's stock is influenced by various factors including whether their wealth/shareholding will increase or decrease. Discuss three methods that firms use to issue additional shares and their effect on shareholders' wealth. (9 marks)

b) Maureen is considering investing in the stock market and has identified two potential stocks in different stock markets that she believes are ideal for her, and has approached you to help her determine which stock she should choose.

	Asset G	Asset Y
Asset Beta	0.8	1.2
91-day treasury bill	10.2%	9.8%
Expected market return	15%	13%

Required:
Using the Capital Asset Pricing Model, advise the best choice of asset that Maureen should undertake if her minimum required rate of return is 14%. (7 marks)

c) Bonds can be defined based on different factors and conditions as specified in their covenants. Elucidate on two different types of bond covenants.
(4 marks)