

THE OPEN UNIVERSITY OF SRI LANKA
COMMONWEALTH EXECUTIVE MASTER OF BUSINESS/PUBLIC
ADMINISTRATION



FINAL EXAMINATION – 2007

MCP 2610 – CORPORATE FINANCE

DURATION : THREE (03) HOURS

Date : 16.12.2007

Time: 9.30 a.m. 12.30 p.m.

NOTE: IMPORTANT INFORMATION

Section A: Question 1 is compulsory

Section B : Answer any three (03) questions in this section, in addition to question No.1.

SECTION A

01. An investor wishes to construct a portfolio consisting of two securities A & B. The expected returns on the two securities and their standard deviations are given below. The correlation coefficient between their returns is -0.5 (minus 0.5)

	Security A	Security B
Expected Return	8%	12%
Standard deviation	0.04	0.06

The investor has several options of the proportion of funds he invests between the two securities A & B. The table below gives each of these options, with the Expected return of the portfolio, and Standard deviation of the portfolio, for options 4,5 and 6.

	Options available					
	1	2	3	4	5	6
Proportion in security A	0%	20%	40%	60%	80%	100%
Proportion in security B	100%	80%	60%	40%	20%	0%
Expected return of Portfolio				9.6%	8.8%	8%
Standard deviation of Portfolio				0.024	0.028	0.040

You are given that the Standard deviation of the portfolio is calculated using the following formula.

$$\sigma_p = \sqrt{w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + 2w_A w_B \rho_{AB} \sigma_A \sigma_B}$$

- i. Fill up the table above, by calculating the Expected Return of the Portfolio, and Standard deviation of the Portfolio for options 1,2 and 3.
- ii. Discuss the results of the table for the 6 different options in terms of a Risk/Return profile considering the riskiness of each individual security, and the proportion invested under each investment option.
- iii. Discuss the relationship between the Correlation coefficient of two securities and its effect on portfolio risk.
- iv. Distinguish between the Beta value as a measure of risk and Standard deviation, which also measures risk. Also discuss the implications of Beta values on the risk level of stocks.
- v. "Organizations are subjected to Systematic and Unsystematic Risk" Explain these two types of risk with examples, and discuss which type/s of risk is reflected in the Beta value of a stock, justifying your answer.
(40 marks)

SECTION B

2.
 - i. Distinguish between Financial institution and Financial markets.
 - ii. Discuss the role of financial markets in an economy
 - iii. What alternate investment opportunities are available to an individual having surplus funds?
(20 marks)

3. Mr. Samson together with a group of friends is considering investment in a project costing \$600,00 for which they are able to collectively contribute \$ 150,000, as their investment. The balance they hope to find external financing, for which several alternative options are being considered.

The project cost is estimated to include the following, whilst the project is expected to be commissioned by 31st January 2008.

Land & Building	\$200,000
Machinery & Equipments	\$180,000
Motor Vehicles	\$ 70,000
Working capital requirements	<u>\$150,000</u>
Total	\$600,000

Machinery Equipments:

Under the terms of the purchase agreement, a credit period of 90 days until 31st March 2008 has been obtained.

Working requirements:

Includes inventory \$110,000, Debtors \$70,000 and credit obtained from raw material suppliers \$30,000.



- i. Advise Samson and his friends of the different alternative funding sources for each asset, giving your reasons of choice.
 - ii. Prepare a projected Balance Sheet as at 31st January 2008 categorizing Fixed & Current Assets, and Current & Long Term Liabilities and Equity. (20 marks)
04. "There are different approaches available for investors to deal with risk". Discuss these approaches giving examples of your own for each of them. (20 marks)
05. i. Discuss how Mergers and Acquisitions, could be used by organizations as a strategy for growth.
 - ii. Explain the methods available to an organization by which they could pay for the interest acquired through the Merger/Acquisition.
 - iii. Discuss the practical issues to be considered, when deciding to pursue a Merger/Acquisition for expansion. (20 marks)

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