

UNIVERSITY OF RUHUNA

Master of Arts in Economics  
2<sup>nd</sup> Semester Examination – April 2017

**MAE 5202 - Financial Economics**

Answer any **Four (04)** questions.

(Using Calculator is permitted.)

Time: **03 Hours**

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- 01.
- i. How do you define the optimal capital structure for a firm. (03 Marks)
  - ii. Distinguish between business risk and financial risk. (06 Marks)
  - iii. Define “target capital structure” What are the factors that determining target capital structure of a firm? (06 Marks)
- 02.
- i. Compare the similarities and dissimilarities between ordinary shares and preferred shares from the view point of the shareholder. (05 Marks)
  - ii. Write a brief account on S and P 20SL price index. (05 Marks)
  - iii. What factors have to be considered by a public limited company when issues the new shares to the market? (05Marks)
- 03.
- i. Define “operating leverage” and “financial leverage”. (03 Marks)
  - ii. Using a simplified version of a hypothetical profit and loss account; illustrate the calculating method of the concepts; the degree of operating leverage (DOL), degree of financial leverage (DFL) and degree of total leverage (DTL) for the period of two consecutive years. (08 Marks)

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- iii. Data in table below is an extract from the financial statement of a firm.

Item	Value (Rs. Million)
Sales	900
Variable cost of goods sold	684
Fixed operating Cost	120

Assuming selling price per unit is Rs. 50/- compute the breakeven point in valuing of sales.

(04 Marks)

04.

- i. Define financial assets with suitable example.  
(02 Marks)
- ii. Briefly explain the financial derivatives.  
(02 Marks)
- iii. Highlight the various functions of derivatives and the significance.  
(04 Marks)
- iv. Explain the differences between arbitrageurs and hedgers in a derivative market.  
(03 Marks)
- v. 'Distinguish between forwards and futures contract.  
(04 Marks)

05.

- i. Identify and briefly explain the various risks faced by the bond's investors in a capital market.  
(03 Marks)
- ii. What are the differences between the bond's coupon rate, current yield, and yield to maturity?  
(03 Marks)
- iii. Explain the meaning of the following equations.

$$YTM(kd) = \frac{INT + \frac{M - Vd}{N}}{\frac{2(Vd) + M}{3}}$$

(03 Marks)

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iv. Suppose that Lion Company has issued a bonds 08 years maturity period, with a face value of Rs.1000, 10 percent coupon rate and semiannual interest payments.

(a) If the required rate of return ( $K_d$ ) is 8 percent, What would be the present value of the Lion bond?

(04 Marks)

(b) Calculate the intrinsic value of the same bond if the interest is paid annually?

(02 Marks)

06.

i. Explain the differences between bull market and bear market.

(02 Marks)

ii. Identify the two main elements of a common stock's expected rate of return ( $\widehat{K}_e$ ).

(03 Marks)

iii. Using dividend capitalization model, write out and explain the valuation model for two period valuation of common stock.

(03 Marks)

iv. Ford Motor Company is paying Rs.4 of dividend for its common stock. Meanwhile, the company expects that dividend may grow by 5 percent per year for next indefinite period. Further required rate of return on Ford stock is 19 percent. Calculate the market value of a stock of Ford.

(03 Marks)

v. 'Southern Rock' company stock paid an annual dividend of Rs. 2.00. The dividends are expected to grow at the rate of 12 percent annually for the next 02 years. Then it is expected to grow at the rate of 8 percent forever. The investors require a return of 10 percent for their investment in the Southern Rock stock. Calculate the fair market price of a share of the common stock.

(04 Marks)

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