**5. Refuse to lend**
If the borrowing company has been involved in un-ethical practices associated with the debt capital borrowed, the lender may withhold the debt capital hence the borrowing firm may not meet its investments needs without adequate capital.
The alternative to this is to charge high interest on the borrower as a deterrent mechanism.

**6. Convertibility:** On breach of bond covenants, the lender may have the right to convert the bonds into ordinary shares.

**3. Agency Relationship Between Shareholders And The Government**
Shareholders and by extension, the company they own operate within the environment using the charter or licence granted by the government. The government will expect the company and by extension its shareholders to operate the business in a manner which is beneficial to the entire economy and the society.

The **government** in this agency relationship is the **principal** while the **company** is the **agent.** It becomes an agent when it has to collect tax on behalf of the government especially withholding tax and PAYE.

The company also carries on business on behalf of the government because the government does not have adequate capital resources. It provides a conducive investment environment for the company and share in the profits of the company in form of taxes.

The company and its shareholders as agents may take some actions that might prejudice the position or interest of the government as the principal. These actions include:

- Tax evasion: This involves the failure to give the accurate picture of the earnings or profits of the firm to minimize tax liability.
- Involvement in illegal business activities by the firm.
- Lukewarm response to social responsibility calls by the government.
- Lack of adequate interest in the safety of the employees and the products and services of the company including lack of environmental awareness concerns by the firm.
- Avoiding certain types and areas of investment coveted by the government.



**Solutions to the agency problem**
The government can take the following actions to protect itself and its interests.

**1. Incur monitoring costs**
E.g. the government incurs costs associated with:
- Statutory audit
- Investigations of companies under Company Act
- Back duty investigation costs to recover tax evaded in the past
- VAT refund audits

**2. Lobbying for directorship (representation)**
The government can lobby for directorship in companies which are deemed to be of strategic nature and importance to the entire economy or society e.g directorship in KPLC, Kenya Airways, KCB etc.

**3. Offering investment incentives**
To encourage investment in given areas and locations, the government offers investment incentives in form of capital allowances as laid down in the Second schedule of Cap 470.

**4. Legislations**

- In case of long-term debt, amount of loan declines with time and repayments reduce its burden to the borrower.
- Debt finance does not influence the company's decision since lenders don't participate at the AGM.

**Disadvantages**

- It is a conditional finance i.e. it is not invested without the approval of lender.
- Debt finance, if used in excess may interrupt the companies decision making process when gearing level is high, creditors will demand a say in the company i.e. and demand representation in the BOD.
- It is dangerous to use in a recession as such a condition may force the company into receivership through lack of funds to service the loan.
- It calls for securities which are highly negotiable or marketable thus limiting its availability.
- It is only available for specific ventures and for a short term, which reduces its investment in strategic ventures.
- The use of debt finance may lower the value of a share if used excessively. It increases financial risk and required rate of return by shareholders thus reduce the value of shares.

**Differences between Debt Finance and Ordinary Share Capital (Equity Finance)**

| | **Ordinary share capital** | | **Debt** |
|---|---|---|---|
| a) | It is a permanent finance | a) | It is refundable (redeemable) |
| b) | Return paid when available | b) | It is fixed return capital |
| c) | Dividends are not tax allowable | c) | Interest on debt is a tax allowable expense |
| d) | Unsecured finance | d) | Secured finance |
| e) | Carry voting rights | e) | No voting right |
| f) | Reduces gearing ratio | f) | Increases gearing ratio |
| g) | No legal obligation to pay | g) | A legal obligation to pay |
| h) | Has a residue claim | h) | Carries a superior claim |
| i) | Owners' finance | i) | Creditors finance. |



**Similarities between Preference and Equity Finance**

a) Both may be permanent if preference share capital is irredeemable (convertible).
b) Both are naked or unsecured finances.
c) Both are traded at the stock exchange
d) Both are raised by public limited companies only
e) Both carry residue claims after debt.
f) Both dividends are not a legal obligations for the company to pay.

**Differences between Preference and Equity Finance**

| Ordinary share capital | Preference share capital |
|---|---|
| a) Has a residue claim both on assets and profit | a) Has a superior claim |
| b) Carries voting rights | b) No voting rights |
| c) Reduces the gearing ratio | c) Increases the gearing ratio |
| d) Variable dividends hence grow over time | d) Fixed dividends hence no growth |
| e) Permanent finance | e) Usually redeemable |
| f) Easily transferable. | f) Not easily transferable |

**Similarities between Debt and Preference Share Capital**

a) Both have fixed returns.
b) Both will increase the company's gearing ratio.
c) Both are usually redeemable.
d) Both do not have voting rights.
e) Both may force the company into receivership
f) Both have superior claims over and above owners.
g) Both are external finances.
h) There is no growth with time.

**Differences between Preference Share Capital and Debt**

| DEBT | PREFERENCE SHARE CAPITAL |
|---|---|
| a) Interest is tax allowable | a) Dividends are not tax allowable |
| b) Interest is a legal obligation | b) Dividends are not a legal obligation |
| c) Debt finance is always secured | c) Preference is not secured finance |
| d) Debt finance is a pre-conditional | d) Is not conditional finance |
| e) Has a superior claim | e) Has a residue claim (after debt) |



**Why It May Be Difficult For Small Companies To Raise Debt Finance In Kenya (Say Jua Kali Companies)**

- Lack of security
- Ignorance of finances available
- Most of them are risky businesses as there are no feasibility studies done (chances of failure have been put to 80%).
- Their size being small tends to make them UNKNOWN i.e. they are not a significant competitor to the big companies.
- Cost of finance may be high – their market share may not allow them to secure debt.
- Small loans are expensive to extend by bank i.e. administration costs are very high.
- Lack of business principles that are sound and difficult in evaluating their performance.

**Solutions to the Above Problems**

- There should be diversification of securities e.g. to accept guarantees.
- Education of such businessmen on sound business principles.
- The government should set up a special fund to assist the jua kali businessmen.
- Encourage formation of co-operative societies.
- To request bankers to follow up the use of these loans.

**3. Bills of Exchange**

Bills of Exchange are a source of finance in particular in the export trade. A Bill of Exchange is an unconditional order in writing addressed by one person to another requiring the person to whom it is addressed to pay to him as his order a specific sum of money. The commonest types of bills of exchange used in financing are accommodation bills of exchange. For a bill to be a legal document; it must be

These are those types of debentures which a company will secure usually in two ways, secured with a fixed charge or with a floating charge.

a) Fixed Charge – a debenture is secured with a fixed charge if it can claim on a specific asset.
b) Floating charge – if it can claim from any or all of the assets which have not been pledged as securities for any other form of debt.

**ii) Naked Debentures**
These are not secured by any of the company's assets and as such they are general creditors.

**iii) Redeemable Debentures**
These are the type of debentures, which the company can buy back after the minimum redemption period and before the maximum redemption period (usually 15 years) after which holders can force the company to receivership to redeem their capital and interest outstanding.

**iv) Irredeemable Debentures (perpetuities)**
These are never bought back in which case they form permanent source of finance for the company. However, these are rare and are usually sold by company's with a history of stable ordinary dividend record.

**v) Classification according to convertibility**
Convertible debentures – Can be converted into ordinary shares although they can also be converted into preference shares.

Conversion price = par value of a debenture/No. of shares to be received.

$$\text{Conversion ratio} = \frac{\text{Par value of debenture}}{\text{Par value of ordinary shares}}$$



**Example**
ABC Company Ltd books:

| | Shs. |
|---|---|
| 10.000, Sh.20 ordinary share capital | 200,000 |
| 10,000, Shs.10 8% preference share capital | 100,000 |
| 5,000, Shs.100 12% debentures | 500,000 |

The above debentures are due for conversion:

**Required**
i) Compute the conversion price
ii) Compute the conversion ratio
iii) Compute new capital structure.

**Solution**

i) Conversion price = par value of debenture/No. of shares to be received.

No. of shares to be received = 100:20 = 5:1

Therefore = $\frac{100}{5} = 20$

ii) Conversion ratio = par value of debenture/par value of share = $\frac{100}{20} = 5.0$

Receive 5 ordinary shares for every 1 debenture held.

b. Asian owned small businesses – They are family owned hence do not require interference of venture capitalists because they are not ready to share profits.
c. African – owned business – need venture capital but have little potential for growth.

6. Focus on low risk ventures e.g confining to low technology, low growth sectors with minimum investment risks.
7. Conservative approach by the venture capitalists.
8. Delay in project evaluation e.g months or more hence entrepreneurs loose interest in the project.
9. Lack of government support and inefficient financial system.

**Summary**
In sum, venture capital, by combining risk financing with management and marketing assistance, could become an effective instrument in fostering developing countries. The experiences of developed countries and the detailed case study of venture capital however, indicate that the following elements are needed for the success of venture capital in any country.

- A broad-based (and less family based) entrepreneurial traditional societies and government encouragement for innovations, creativity and enterprise.
- A less regulated and controlled business and economic environment where attractive customer opportunities exists or could be created from high-tech and quality products.
- Existence of disinvestments mechanisms, particularly over-the counter stock exchange catering for the needs of venture capitalists.
- Fiscal incentives which render the equity investment more attractive and develops ‘equity cult’ in investors.
- A more general, business and entrepreneurship oriented education system where scientists and engineers have knowledge of accounting, finance and economics and accountants understand engineering or physical sciences.
- An effective management education and training programme for developing professionally competent and committed venture capital managers; they should be trained to evaluate and manage high technology, high risk ventures.
- A vigorous marketing thrust, promotional efforts and development strategy, employing new concepts such as venture fair clubs, venture networks, business incubators etc. for the growth of venture capital.
- Linkage between universities, technology institutions, R & D. Organisations, industry, and financial institutions including venture capital firms.
- Encouragement and funding or R & D by private public sector companies and the government for ensuring technological competitiveness.

**Disadvantages of Venture Capital**
- Dilute ownership position of a firm
- Dilute control of a firm



## REINFORCING QUESTIONS

**QUESTION ONE**
a) What are the practical difficulties of a small scale enterprise wishing to obtain credit to expand production? (10 marks)

b) Distinguish between internal and external sources of finance for a limited liability company. (10 marks)

**QUESTIONTWO**
a) Why do different sources of finance have different costs? (8 marks)

expected future interest rates are equal to forward rates computed from the expectations with regard to future interest rates are. Other factors which affect the expectations with regard to future interest rates are:

- Political stability
- Monetary policy of the government
- Fiscal policy of the government (government expedition)
- Other economic related factors including social factors.

The following conditions are necessary for the expectation theory to hold.

i) Perfect capital markets exists where there are many buyers and sellers of security with non having a significant influence on the interest rates.
ii) Investors have homogeneous expectations about future interest rates and returns on all investments.
iii) Investors are rational wealth maximizers
iv) Bankruptcy of firms due to use of borrowing is unlikely.

**3. Market Segmentation Theory**

This theory states that the major investors (borrowers and lenders) are confined to a particular segment of the market and will not change even if the forecast of the likely future interest rates changes.

The lenders and borrower thus have a preferred maturity e.g a person borrowing to buy a house or a company borrowing to build a power plant would want a long term loan. However a retailer borrowing to build up stock in readiness for a peak reason would prefer a short term loan. Similar differences exist among savers e.g a person saving to pay school fees for next semester would want to lend on in the short-term market. A person saving for retirement 20 years ahead would probably buy long-term security in L.T market.

The thrust of market segmentation theory is that the slope of yield curve depends on demand and supply mechanism. An upward sloping curve would occur if there was a large supply of funds relative to demand in the short term marketing but a relative shortage of funds in the long-term market would produce an upward sloping curve.



**Tests of the 3 theories**

Various test have been conducted mainly in USA and they indicate that all the 3 theories have some validity and thus the shape of the yield curve of any firm is affected by the following:

1. Supply and demand conditions in the short and long term market.
2. Liquidity preferences of lenders and borrowers
3. Expectation of future inflation. While any of the 3 factors may dominate the market all the 3 effect the term structure of interest rate.

Factors influencing interest rates

There are four most important factors that influence interest rates and the shape of yield curve.

1. CBK – Monetary policy
2. The level of government budget deficit
3. Balance of trade position
4. Business activity (circle) in the economy

**1. CBK – Monetary Policy**

The money supply in the economy has a major effect on both the level of economic activity and the rate of inflation. The level of money supply is controlled by the CBK.

The amount invested to derive the returns is equal to the buying price at the beginning of the period ($P_0$) therefore percentage return/yield =

$$\frac{\text{Total returns}}{\text{Investment}} \times 100 = \frac{DPS + P_1 - P_0}{P_0} \times 100$$

**Illustration:**
For the past 5 years, the MPS and DPS for XYZ Ltd were as follows:

| | 1998 | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|---|
| | Shs. | Shs. | Shs. | Shs. | Shs. |
| MPS as at 31st Dec | 40 | 45 | 53 | 50 | 52 |
| DPS for the year | - | 3 | 4 | 3 | - |

**Required**
Determine the estimated cost of equity/shareholders percentage yield for each of the years involved.

**Solution**

| Year | MPS | Capital gain | DPS | % Return |
|---|---|---|---|---|
| 1998 | 40 | - | - | - |
| 1999 | 45 | 5 | 3 | $\frac{5+3}{40} x100 = \frac{8}{40} x100 = 20\%$ |
| 2000 | 53 | 8 | 4 | $\frac{8+4}{45} = \frac{12}{45} x100 = 27\%$ |
| 2001 | 50 | -3 | 3 | $\frac{-3+3}{53} = \frac{0}{53} x100 = 0\%$ |
| 2002 | 52 | 2 | - | $\frac{2+0}{50} = \frac{2}{50} x100 = 4\%$ |



iii) **Capital asset pricing model (CAPM)** – CAPM is a technique that is used to establish the required rate of return of an investment given a particular level of risk. According to CAPM, the total business risk of the firm can be divided into 2:

**Systematic Risk** – This is the risk that affects all the firms in the market. This risk cannot be eliminated/diversified. It is thus called undiversifiable risk. Since it affects all the firms in the market, the share price and profitability of the firms will be moving in the same direction i.e. systematically. Examples of systematic risk are political instability, inflation, power crisis in the economy, power rationing, natural calamities – floods and earthquakes, increase in corporate tax rates and personal tax rates, etc. Systematic risk is measured by a Beta factor.

**Unsystematic risk** – This risk affects only one firm in the market but not other firms. It is therefore unique to the firm thus unsystematic trend in profitability of the firm relative to the profitability trend of other firms in the market. The risk is caused by factors unique to the firm such as:

- Labour strikes by employees of the firm;
- Exit of a prominent corporate personality;
- Collapse of marketing and advertising programs of the firm on launching of a new product;
- Failure to make a research and development breakthrough by the firm, etc

| | | |
|---|---|---|
| Cost of goods sold | 360,000 | 330,000 |
| Stock at 31 December | 100,000 | 60,000 |
| Debtors at 31 December | 98,000 | 102,000 |
| Creditors at 31 December | 40,000 | 25,000 |
| Total assets at 31 December | 300,000 | 185,000 |

Stock and debtors at 1 January 1994 amounted to Sh.70,000 and Sh.98,000 respectively.

**Required**

a) Calculate the rate of stock turnover expressed:

i) As a ratio; (3 marks)
ii) In days, for each of the years 1994 and 1995. (3 marks)

b) Calculate the rate of collection of debtors, in days, for each of the years 1994 and 1995. (3 marks)

c) Calculate the rate of payment to creditors, in days, for each year 1994 and 1995. (3 marks)

d) Show the cash operating cycle for each year. (6 marks)

e) Comment on the results. (6 marks)

**QUESTION FOUR**

a) Briefly explain the meaning of a "floating rate" bond. (4 marks)
b) From the point of view of a company's financial manager, outline the merits and demerits, to the company, of issuing floating rate debt as a means of raising capital. (16 marks)



**QUESTION FIVE**

The Altman formula for prediction of bankruptcy is given as follows:

$$Z \text{ score} = 1.2X_1 + 1.4X_2 + 3.3X_3 + 1X_4 + 0.6X_5$$

Where: $X_1$ = Working capital/Total assets
$X_2$ = Retained earnings/Total assets
$X_3$ = Earnings before interest and tax/Total assets
$X_4$ = Sales/Total assets
$X_5$ = Market value of Equity/Liabilities

In this model, a Z-score of 2.7 or more indicates non-failure and a Z-score of 1.8 or less indicates failure.

You are provided with the following information in respect of four listed companies.

| | Working capital | Retained earnings | Earnings before interest and tax | Market value of equity | Total assets | Liabilities | Sales |
|---|---|---|---|---|---|---|---|
| | Sh.'000' | Sh.'000' | Sh.'000' | Sh.'000' | Sh.'000' | Sh.'000' | Sh.'000' |
| A | 4,000 | 60,000 | 10,000 | 20,000 | | 120,000 | |
| Ltd | 2,000 | 20,000 | 0 | 5,000 | 200,000 | 80,000 | 200,000 |

**Methods of Analyzing Investment**
**Capital Budgeting Methods.**
There are two methods of analyzing the viability of an investment:

**a) Traditional methods**

- Pay back period method
- Accounting rate of return method

**b) Modern methods (Discounted cash flow techniques)**

- NPV – Net present value method
- IRR – Internal rate of return method
- PI – Profitability index method

For the above two (a & b) methods to be used, they have to meet the following:

i) They should rank ventures available in the investment market according to their viability i.e. they should identify which method is more viable than others.
ii) They should rank a venture first if the venture brings in return earlier and in large lumpsums than if a venture brought in late and less inflows over the same period.
iii) Should rank any other projects as and when it is available in the investment market. Such methods should take into account that all returns (inflows), must be cash returns as it is necessary to be able to finance the cost of the venture.

## TRADITIONAL METHODS

### Pay back period method

This method gauges the viability of a venture by taking the inflows and outflows over time to ascertain how soon a venture can payback and for this reason PBP (or payout period or payoff) *is that period of time or duration it will take an investment venture to generate sufficient cash inflows to payback the cost of such investment.* This is a popular approach among the traditional financial managers because it helps them ascertain the time it will take to recoup in form of cash from operations the original cost of the venture. This method is usually an important preliminary screening stage of the viability of the venture and it may yield clues to profitability although in principle it will measure how fast a venture may payback rather than how much a venture will generate in profits and yet the main objectives of an investment is not to recoup the original cost but also to earn a profit for the owners or investors.

Computation of payback period:

**1.** **Under uniform annual incremental cash inflows** – if the venture or an asset generates uniform cash inflows then the payback period (PBP) will be given by:

$$PBP = \frac{\text{Initial cost of the venture}}{\text{Annual incremental cost}}$$

e.g. If a venture costs 37,910/= and promises returns of 10,000/= per annum indefinitely then the PBP =

$$\frac{37,910}{10,000} = 3.79 \text{ years}$$

The shorter the PBP the more viable the investment and thus the better the choice of such investments.

**2.** **Under non-uniform cash inflows:**
Under non-uniformity PBP computation will be in cumulative form and this means that the net cash inflows are accumulated each year until initial investment is recovered.

**Example**
Assume a project costs Sh.80,000 and will generate the following cash inflows:

| **Cash inflows** | | | **Accumulated inflows** |
|---|---|---|---|
| Inflows year 1 | = | 10,000 | 10,000 |
| Inflows year 2 | = | 30,000 | 40,000 |
| Inflows year 3 | = | 15,000 | 55,000 |
| Inflows year 4 | = | 20,000 | 75,000 |
| Inflows year 5 | = | 30,000 | 105,000 |

The Sh.80,000 cost is recovered between year 4 and 5. During year 5 (after year 4) Sh.5,000 is (80,000 – 75,000) is required out the total year 5 cash flows of 30,000.

$$\text{Therefore the PBP} = 4 + \frac{5,000}{30,000} = 4.17 \text{ years}$$



**Example**
Cedes limited has the following details of two of the future production plans. Only one of these machines will be purchased and the venture would be taken to be virtually exclusive. The Standard model costs £50,000 and the Deluxe cost £88,000 payable immediately. Both machines will require the input of the following:

i) Installation costs of £20,000 for Standard and £40,000 for the Deluxe
ii) A £10,000 working capital through their working lives.

Both machines have no expected scrap value at end of their expected working lives of 4 years for the Standard machine and six years for the Deluxe. The operating pre-tax net cash flows associated with the two machines are:

| Year | 1 | 2 | 3 | 4 | 5 | 6 |
|---|---|---|---|---|---|---|
| Standard | 28,500 | 25,860 | 24,210 | 23,410 | - | - |

$$Pv = \frac{A}{(1+K)^N}$$

Where: A = annual cash flows
N = Number of years

Also, the present value of a shilling to be received at a given point in time can in addition to using the above formula, be found using the present value tables.

Suppose that an investor can expect to receive:

40,000 at the end of year 2
70,000 at the end of year 6
100,000 at the end of year 8

Compute his present (value) if his time preference is 12%.

$$Pv = \frac{L}{(1+K)^N} = \frac{40,000}{(1.12)^2} + \frac{70,000}{(1.12)^6} - \frac{100,000}{(1.12)^8}$$

= Kshs.107,740.26

Using tables:

= 40,000(0.7992) + 70,000(0.5066) + 100,000(0.4039)
= 107,820

**3. Present Value of an Annuity**
An individual investor may not necessarily get a lumpsum after some years but rather get a constant periodic amount i.e. an annuity for certain number of years. The present value of an annuity receivable where the investor time preference is 10% equal to:



$$Pv(A) = \frac{A}{(1+i)}$$ I = time preference rate

E.g. Pv of 1/= to be received after 1 year if time preference rate is 10%.

$$= \frac{1}{1+0.1} = 0.909$$

After 2 years it will be: $\frac{A}{(1+i)^2} = \frac{1}{(1.1)^2} = 0.8264$

| | | |
|---|---|---|
| 1st year | - | 0.9090 |
| 2nd year | - | 0.8264 |
| 3rd year | - | 0.7513 |
| 4th year | - | 0.6830 |
| Total | - | 3.1697 |

**4. Present Value of Uneven Periodic Sum**
In investment decisions it is very rare to get even periodic returns and in most cases a company will generate a stream of uneven cash inflows from a venture and the present value of those uneven periodic sums is equal to:

## COMPARISON OF METHODS

Both traditional and modern methods will show or indicate strong weaknesses such that a company cannot use either to select a viable venture and for this reason the selection of the investment will depend on which method the company has identified it can meet its investment needs. The choice should not be limited to one method but at least 2 modern methods. In all, when ranking projects, a conflict will rise between IRR and NPV especially under the following conditions:

i) If the lives of the projects are different.
ii) Where the cash outlay is larger than the other.
iii) When the cash flow pattern differs i.e the cash flows of one project may overtime increase while those of the other decrease. In this case NPV may give consistently correct solution especially so because it does not yield multiple rates.

## PBP RECIPROCAL

PBP expresses the profitability of a project in terms of years. It does not show any return as measure of investment. The PBP reciprocal has been utilised to rectify the situation, but it is only of value where the pattern of cash flow is relatively consistent and where the life of the asset is at least double the payback period of the asset. The payback period is expressed as:

$$\frac{\text{Investment}}{\text{Annual cash flows}}$$

This PBP reciprocal is often used as a guide to ascertain the discount factor in discounted cash flow calculations i.e. to approximate IRR.

$$\text{Payback period reciprocal} = \frac{1}{PBP} \times 100$$



## REPLACEMENT OF ASSETS

**Example**

Estate Developers purchased a machine five years ago at a cost of £7,500. The machine had an expected economic life of 15 years at the time of purchase and a zero estimated salvage value at the end of 15 years. It is being depreciated on a straight line basis and currently has a book value of £5,000. The Financial Manager has conducted a feasibility study aimed at acquiring a new machine for £12,000 and is depreciated over its 10 years useful life. The new machine will expand sales from £10,000 to £11,000 per annum and will reduce labour and materials usage sufficiently to cut operating cost from £7,000 to £5,000. The salvage value of the new machine is £2,000 at the end of useful life. The current market value of the old machine is £1,000 and tax is 40%. The firms cost of capital is 10%. The financial manager wishes to make a decision on whether to replace the old machine with a new one and he seeks your held.

N.B. The decision to replace takes into account the following:

a) Estimate the actual cash outlay attributable to the new machine
b) Determine the incremental cash flows.
c) Compute the NPV of incremental cash flows.
d) Add up the present value of the expected salvage value to the P.V. of the incremental cash flow.
e) Ascertain whether the NPV (net present value) is positive or whether the IRR (internal rate of return) exceed the cost in which case invest if its positive.

**Solution**

| | | | |
|---|---|---|---|
| a) | Initial capital for new machines | | £ |
| | Cash price of new machine | | 12,000 |
| | Less market value of old machine | | (1,000) |
| | Less tax shield on sale of old machine: | | |
| | Market value | 1,000 | |

1. **Organised Exchange and Over the Counter (OTC) market**
   This is where the buying and selling of securities is done by buyers and sellers are not present but only the agents (brokers) internet. This system is called "open outcry".

2. **Over the Counter Market (OTC)**
   Provides an opportunity for unlisted/unquoted firms to sell their security
   OTC is usually organized by the dealers or stock brokers who buy securities themselves and then sell them.
   They maintain a reasonable balance between demand and supply and observe price movements to determine profit margins on sale.
   Trading may be done through telephones, computer networks, fax etc.
   The dealers/participants set the trading rules OTC specialize in securities such as corporate bonds, equity securities, Treasury bonds etc.
   OTC is underdeveloped in Kenya.

**Features of OTC Markets**

1. Prices are relatively low
2. Usually deal with new securities of firms
3. Is composed of small and closely held firms.

**FINANCIAL INTERMEDIARIES**

These are institutions which mediate/link between the savers and investors:

**Examples of financial intermediaries in Kenya.**

**1. Commercial Banks.**

They act as intermediary between savers and users (investment) of funds.



**2. Savings and Credit Associations**

These are firms that take the funds of many savers and then give the money as a loan in form of mortgage and to other types of borrowers. They provide credit analysis services.

**3. Credit Unions**

These are cooperative associations whose members have a common bond e.g employees of the same company. The savings of the member are loaned only to the members at a very low interest rate e.g. SACCOS charge p.m. interest on outstanding balance of loan.

**4. Pension Funds**

These are retirement schemes or plans funded by firms or government agencies for their workers. They are administered mainly by the trust department of commercial banks or life insurance companies. Examples of pension funds are NSSF, NHIF and other registered pension funds of individual firms.

**5. Life Insurance Companies**

These are firms that take savings in form of **annual premium** from individuals and them invest, these funds in securities such as shares, bonds or in real assets. Savers will receive annuities in future.

**7. Barometer of the Economy**

At the Stock Exchange, share prices rise and fall depending, largely, on market forces. Share prices tend to rise or remain stable when companies and the economy in general show signs of stability. Therefore their movement of share prices can be an indicator of the general trend in the economy.

**Advantages of Investing In Shares**

**1. Income in form of dividends**

When you have shares of a company you become a part-owner of that company and therefore you will be entitled to get a share of the profit of the company which come in form of dividends. Furthermore, dividends attract a very low withholding tax of 5% only.

**2. Profits from Capital Appreciation**

Shares prices change with time, and therefore when prices of given shares appreciate, shareholders could take advantage of this increase and set their shares at a profit. Capital gains are not taxed in Kenya.

**3. Share Certificate can be used as a Collateral**

Share certificate represents a certain amount of assets of the company in which a shareholder has invested. Therefore this certificate is a valuable property which is acceptable to many banks and financial institutions as security, or collateral against which an investor can get a loan.

**4. Shares are easily transferable**

The process of acquiring or selling shares is fairly simple, inexpensive and swift and therefore an investor can liquidate shares at any moment to suit his convenience.

**5. Availability of Investment Advice**

Although the stick market may appear complex and remote to many people. Positive advise and guidance could be provided by the stockbrokers and other investment advisors. Therefore, an investor can still benefit from trading in shares even though he may not be having the technical expertise relevant to the stock market.

**6. Participating in Company Decisions**

By buying shares and therefore becoming a part-owner in an enterprise, a shareholder gets the right to participate in making decisions about how the company is managed. Shareholders elect the directors at the Company's Annual.

General meetings, whereby the voting power is determined by the number of shares an investor holds since the general rules is that one share is equal to one vote.

**STOCK MARKET TERMINOLOGY**

**1. BROKER**

- A dealer at the market who buys and sells securities on behalf of the public investors.
- He is an agent of investors
- He is the only authorized person to deal with the quoted securities. He is authorized by CMA and NSE
- He obtains the suitable deal for his clients/investors, gives financial advice and charges commission for his services.
- He doesn't buy or sell shares in his own right hence he cannot be a market marker.
- He must maintain standards set by the stock exchange.

**2. JOBBERS/SPECULATORS**

- This is a dealer who trades in securities in his own right as a principal.
- He can set prices and activate the market through his own buying and selling hence he is a market maker.
- He engages in speculation and earns profit called Jobbers' turn (selling price – buying price).
- He does not deal with members of the public unlike brokers. However, brokers can buy and sell shares through jobbers.

There are 3 types of jobbers

**a) Bulls**

- A jobber buy shares when prices are low and hold them in anticipation that the price will rise and sell them at gain.
- When a market is dominated by bulls (buyers predominate sellers), it is said to be bullish. The share prices are generally rising.
- Therefore the market is characterized by an upward trend in security prices.
- It signifies investors confidence/optimism in the future of economy.

**b) Bears**

- A speculator/jobber who sells security on expectation of decline in prices in future.
- The intention is to buy same securities at lower prices in future thereby making a gain.
- When market is dominated by bears (sellers predominate buyers) it is said to be bearish.

The merchant banks act as a principal when they buy share from the company before the issue is made. Merchant banks accept bills of exchange which deal in the leasing of industrial equipment.

**QUESTION ONE**

The following information is reported in a daily newspaper with respect to shares traded on the Nairobi Stock Exchange:

| | Last 12 months H Shs. | L Shs. | Security | Yesterday Shs. | Previous Deal Shs. | Shares traded |
|---|---|---|---|---|---|---|
| 1 | 200.00 | 75.00 | Kakuzi Limited Ord. Sh.5 | 120.00 | 130.00CD | 10,000 |
| 2 | 90.50 | 43.50 | Express Kenya Ltd. Ord. Sh.5 | | 43.50 | |
| 3 | 40.00 | 4.00 | ATH Ltd. Ord. Sh.10 | Suspended | | |
| 4 | 362.00 | 102.00 | Unga Ltd. Ord. Sh.5 | 317.00CB | 318.00 | |
| 5 | 140.00 | 90.00 | Barclays Bank Ltd. Ord. Sh.10 | 90.00 | 90.00 | |

**Required**

a) Why does the price of a share change? (6 marks)

b) i) What does the CD against Kakuzi's share price mean? (2 marks)
ii) Under the yesterday's column for Express Kenya Ltd., there is a dash (-). Explain. (2 marks)
iii) ATH is indicated as suspended. Explain why a company may be suspended from the stock exchange. (6 marks)
iv) Explain the CB against the Unga share price. (2 marks)
v) What is the meaning of the Ord. Sh.10 indicated against the Barclays Bank? 2 marks)

**(Total: 20 marks)**



**QUESTION TWO**

a) In relation to capital markets, differentiate between the terms stock markets and financial markets. (4 marks)

b) The Nairobi Stock Exchange is set to undergo major changes in terms of services when the Central Depository System (CDS) is put in place after the Parliament passes the Bill on the issue.

i) What is the Central Depository System (CDS)? (4 marks)
ii) How will it benefit the parties to be affected by it? (4 marks)

c) The shares of Ndege Airways Company Ltd. have been trading at Sh.8.00 per share for the last several months. The existing shareholders argue that such shares are undervalued. They say that, the shares should normally be trading at around Sh.15 per share.

i) When would a share price said to be unfair? (4 marks)
ii) If the price earnings ratio for Nege Airways Company Ltd. ordinary shares is 2.5 imes while the price earnings ratio of the shares of Piki Piki Company Ltd. is 10 times, which share is more attractive to a potential investor? Give reasons. (4 marks)