

CHUKA



UNIVERSITY

## UNIVERSITY EXAMINATIONS

**EXAMINATION FOR THE AWARD OF DEGREE OF MASTER OF BUSINESS  
ADMINISTRATION**

**MBAD 823: CORPORATE FINANCE****STREAMS: MBAD Y2S1****TIME: 3 HOURS****DAY/DATE: WEDNESDAY 07/04/2021****8.30 A.M – 11.30 A.M****INSTRUCTIONS:****Answer all question****QUESTION ONE**

- (a) Discuss the criticism of Modigliani and Miller hypothesis on dividend decision.

[6

marks]

- (b) ABC limited is in a risk class and the capitalization rate is 12%. It has 4000 outstanding shares selling at ksh150 each. The total dividend paid the current financial year is ksh 32,000. The company expects to have a net income of ksh 60,000 and a proposal of new investment of ksh 120,000.

**Required :**

Show that under MM hypothesis, dividend payment has no effect on the value of the firm. [6 marks]

- (c) Dona limited is taking over Heron limited. The shareholders of Heron would receive 0.8 shares of Dona for each share held by them. The data for the companies is as follows:

	Dona	Heron
Net sales	800,000	500,000
Profit after tax	400,000	150,000
No. of share	100,000	60,000
Earnings per share	4	2.5
Marketing price per share	100	60

Price earnings ratio	25	24
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**Required:**

Compute the combined EPS,MPS,PER and the total market capitalization rate. [8 marks]

(d) Explain the defense tactics or mechanisms a firm would use against takeovers.

[8

marks]

(e) The following information has been extracted from the books of Hamisi limited:

Earnings before tax                      5,000,000

No. of outstanding share   100,000

Tax rate is                                      40%

Return on equity                              8%

Dividend payout ratio                      70%

Cost of capital                                12%

**Required :**

(i) Calculate the value of the firm using Gordons model [3 marks]

(ii) Calculate the value of the firm using Walter's model. [3 marks]

(f) Describe the classification of lease financing. [6 marks]

**QUESTION TWO**

(a) Haltons limited has 1,200,000 shares outstanding at a current market price of ksh 150 per share. The company needs 20,000,000 to finance its proposed project. The board of directors has decided to issue rights for raising required funds. The subscription price has been fixed at ksh 50 per share.

**Required :**

- (i) How many rights are required of purchase one new share
  - (ii) What is the price of one share after rights issue
  - (iii) Compute the theoretical value of the share
  - (iv) Consider the effect of the rights issue on shareholders wealth under 3 options available to shareholders (assume that shareholders have 3 shares and ksh 50 cash at hand) [8 marks]
- (b) Company U and L are all identical in every aspect except that U is unlevered while L has 20 million 10% bonds. The cost of equity for the unlevered firm is 12%. Both firms have earnings after tax (EAT) of ksh 5 million. Tax rate is 30%.

**Required :**

- (i) Determine the value of the firm for each case. [2 marks]
- (ii) Determine the cost of equity of both firms. [2 marks]
- (iii) Determine the overall cost of payment for both forms. [2 marks]
- (c) Discuss factors affecting dividend payment of a firm. [6 marks]

**QUESTION THREE**

- (a) The following is the income statement and statement of financial position for Almasi enterprises 31.12.2016.

**Income statement**

Sales	10000
Cost of sales	<u>6000</u>
Income	4000
Taxes (30%)	<u>1200</u>
Earnings	2800
Less : dividends	<u>1800</u>
Retained earnings	<u>1000</u>

**Statement of financial position**

Fixed Assets	
Land and buildings	30,000
Machinery	20,000
Current Assets	
Cash	12,000
Debtors	8,000
Stock	<u>4,000</u>
	<u>74,000</u>
Financed by:	
Ordinary share capital	48,500
Retained earnings	6,000
Long term debt	15,000
Creditors	3,000
Bank overdraft	<u>1,500</u>
	<u>74,000</u>

**Additional information**

The sales will increase by 15% in 2017 and 30% in 2018.

Dividend payout ratio is 60%

Tax rate is 30%

**Required:**

- (i) Determine the amount of external finance requirement for the next 2 years.

[7

marks]

- (ii) Prepare a proforma balance sheet as at 31.12.2018.

[7 marks]

- (b) Describe the components of financial planning models.

[6 marks]

**QUESTION FOUR**

- (a) A company wants to acquire an asset that costs 500,000 for 5 years. The company is to depreciate the asset using straight line method. There are two financing alternatives either leasing or borrowing to buy the asset.

The loan has an interest rate of 16% paid in equal year end instalments or a lease that will be set to amortise the cost of the equipment over the lease period, the return on capital of the lessor is 15%. The corporate tax rate is 40% and no salvage value. Advise the company on whether to lease or buy the asset. [12 marks]

- (b) The following information relates to the return of stock of company P.

Economic state	Probability	Return of stock A	Return of the market
Good	0.25	18	16
Normal	0.4	-15	14
Bad	0.35	16	12

Calculate the beta of the security [5 marks]

- (c) Briefly explain the forms of capital market efficiency. [3 marks]

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