CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 332: CORPORATE FINANCE

STREAMS:Y3S1 **TIME: 2 HOURS**

DAY/DATE: WEDNESDAY 4/12/2019 **2.30 P.M – 4.30 P.M**

INSTRUCTIONS
Answer question one and any other three questions

QUESTION ONE

(a) ABC ltd has 1 million shares outstanding at current market price of ksh 100 per share. The company announces plans to raise ksh 10 million of new equity capital through a rights offering, and it decides to sell the new shares to shareholders for ksh 80 per share. Assume a shareholder owns eight shares.

Required ;

Advise the shareholder whether to exercise ,ignore or sell right. [6 marks]

(b) Explain any four reasons why a company may adopt leasing as a source of long term financing. [4 marks]

(c) Bora ltd has earnings before interest and taxes (EBIT) of ksh 10 million . The company has ksh 60 million of debt outstanding with a required rate of 6.5 per cent. Assume that there are corporate taxes of 30% . The rate of return required by shareholders on all equity firm is 10%. The personal taxes of 10% on common stock income and 35% on debt income exist.

Required :

The gain from leverage and value of the firm. [6 marks]

(d) Briefly explain the pecking order theory of capital structure. [4 marks]

(e) Huge ltd and Tint ltd are companies operating in the same line of business. In the past few years huge limited has experienced competition from Tny limited to an extent that huge limited is now contemplating acquiring Tiny limited to consolidate its market share. The following financial data is available for the two companies:

	Huge ltd	Tiny ltd
Annual sales (millions)	Ksh 375	Ksh 45
Net income (millions)	Ksh 30	Ksh 3.75
Outstanding shares (millions)	7.5	1.5
Earnings per share (EPS)	Ksh 4	Ksh 2.5
Market per share	Ksh 42	Ksh 18

Required:

(i) Maximum exchange ratio huge ltd should agree to if it expects no dilution in its EPS. [3 marks]

(ii) The earnings per share of Tiny ltd after merger. [3 marks]

(iii) The post merger market per share of Tiny ltd. [2 marks]

(iv) Given that the growth rate of huge ltd is 7% while that of tiny ltd is 12% compute the combined growth rate of the two companies. [2 marks]

QUESTION TWO

(a) Explain any four defensive mechanisms by corporations against takeovers. [8 marks]

(b) Companies A and B are identical in every respect except that A ltd is unlevered while B ltd has 5%, ksh 10 million debentures outstanding in its capital. The earnings before interest and tax for both companies are 2 million. The earnings are expected to remain constant indefinitely. The cost of equity for company A is 10% and the corporate tax rate is 30%.

Required :

(i) Determine the value MM would estimate for each firm. [4 marks]

(ii) Determine the cost of equity each firm. [4 marks]

(iii) The overall cost of capital for both firms. [4 marks]

QUESTION THREE

(a) Describe the clientele theory of dividends. [4 marks]

(b) ABC ltd is considering whether it would be financially advisable to retire to existing long term debt with a cheaper loan. The current loan of ksh 10 million has an annual interest charge of 15% and has 10 years to maturity. The company has ksh 125,000 of unamortized loan expenses still in its books. If the company decides to redeem the loan, there is an early payment penalty amounting to 10% of the loan. A new ksh 10 million loan can be raised at 13% per annum for a ten year period. It is expected that underwriting costs will amount to ksh 600,000. The overlapping interest period between issues will be two months during which interest will be paid on the old bonds and funds borrowed will initially be invested in treasury bonds at at interest tax 6% p.a before used for refunding. Assume a tax rate of 30%.

Required :

(i) Calculate the net amount of cash investment required for the refunding of the loan. [8 marks]

(ii) Compute the annual cash savings which result from refunding. [6 marks]

(iii) Determine whether refunding is advantageous to the company. [2 marks]

QUESTION FOUR

(a) Describe any three ways corporate entities can prevent imminent corporate failure. [6 marks]

(b) Bidi ltd has a cost of equity of 10%. The company currently has 250,000 shares outstanding and selling on the securities exchange at ksh 120 per share. The company's earnings are ksh 10 per share and it intends to maintain a dividend payout ratio of 50% at the end of the financial year. The company's expected net income is 3 million and the available investment proposals are estimated to require ksh 6 mi llion.

Required :

Using the Modigliani and miller (MM) proposition on dividend irrelevance, show that the payment of dividends does not affect the value of the firm. [14 marks]
