CHUKA UNIVERSITY

UNIVERSITY EXAMINATIONS

THIRD YEAR EXAMINATION FOR THE AWARD OF DEGREE OF BACHELOR OF COMMERCE

BCOM 332: CORPORATE FINANCE

STREAMS: BCOM **TIME: 2 HOURS**

DAY/DATE: TUESDAY 05/12/2017 **2.30 P.M. – 4.30 P.M.**

INSTRUCTIONS: ANSWER QUESTION ONE AND ANY OTHER TWO QUESTIONS

(a) ABC limited belongs to a risk class for which the appropriate capitalization rate is 10%. It has 5000 outstanding shares selling at sh. 100 each. The firm is contemplating declaration of a dividend of sh. 6 per share at the end of the current financial year. The company expects to have a net income of sh 50, 000 and has a proposal of making new investment of sh. 100,000.

Required:

Show under MM hypothesis that the payment of dividend does not affect the value of the firm. [8 marks]

(b) Company A and B are in the same risk class and are identical in every respect except that company A is levered while B is not. Company A has sh. 6 million 5% bonds. Both companies earn 10% before interest and tax on their sh. 10 million total assets. The equity capitalization rate is 10%.

Required:

(i) Compute the value of unlevered firm

(ii) The value of levered firm

(iii) The value of the levered firm if tax rate of 50% exists [6 marks]

(c) Explain any three forms of dividend. [6 marks]

(d) Distinguish between right issue and a bonus issue. [3 marks]

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

Earning after tax 8 million

Number of outstanding shares 1 million

Dividend payout ratio 60%

Cost of capital 10%

Internal rate of return form investment 12%

Required:

(i) Calculate the market value of the company using Walters model. [4 marks]

(ii) Outline the limitations of using the above model. [3 marks]

QUESTION TWO

(a) Explain the motives behind leasing as a form of financing. [4 marks]

(b) A company is interested in acquiring an asset costing 1, 200,000 it has two options.

(i) To borrow the amount at 14% interest per annum repayable in 5 years.

(ii) To take on lease that asset for a period of a5 years at the year-end rentals of 180,000

Tax rate is 30% and depreciation is on straight line method.

The asset will have a salvage value of sh 200,000

Required:

Advice the company whether to lease or buy the asset. [14 marks]

(c) Differentiate between systematic and unsystematic risk. [2 marks]

QUESTION THREE

(a) A company has been experiencing losses as a respect of poor financial performance, it has been threatened with merger and yet the company is not interested. They have approached you to advise them on the tactics they can use to prevent the merger.

[6 marks]

(b) X limited is taking over y limited. The relevant data for the two companies is as follows:

	Company X	Company Y
Profit after tax	58,000	12,000
Number of shares	12,000	3,000
Earnings per share	5.2	4.0
Market price per share	30	20
Price earnings ratio	8	5

Required post-merger:

(i) Earnings per share

(ii) Price earnings ratio

(iii) Market price per share

(iv) Number of shares

(v) Total market capitalization [10 marks]

(c) Using a well labeled diagram, explain the risk diversification. [4 marks]

QUESTION FOUR

(a) Highlight the steps involved in financial planning. [6 marks]

(b) The following is the balance sheet of Bimbo limited as at 31st Dec 2013

Fixed assets	15,000
Land	8,000
Machinery	5,000
Equipment	
Current assets	
Cash	3,500
Debtors	5,500
Stock	3,000
	40,000
Financed by:	
Ordinary share capital	24,000
Retained earnings	4,000
15% long term debt	5,000
Creditors	4,500
Accrued expenses	2,500
	40,000

Additional information:

- Sales for the year ended 31st December 2013 amounted to 50 million the sales will increase by 15% in 2014 and 20% in 2015
- The after tax profit on sales is 201%
- The company dividend payout ratio is 75%

Required:
Determine the amount of external finance for the next two years and prepare a proforma balance sheet as at 31st December 2015. [1 4marks]
