CHUKA UNIVERSITY COLLEGE

UNIVERSITY EXAMINATIONS

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

BCOM 332: CORPORATE FINANCE

STREAM: BCOM Y3S1 **TIME: 2 HOURS**

DAY/DATE: TUESDAY 18/12/2012 **2.30 P.M. – 4.30 P.M**

INSTRUCTIONS:

Answer question ONE and other TWO questions
Do not write on the question paper.

QUESTION ONE (30 MARKS)

(a) Describe the scope of corporate finance. [3 Marks]

(b) Three assets have the following distribution of returns:

	Rate of return (%)		
Probability of occurrence	A_1	A_2	A_3
0.1	6	14	2
0.2	8	12	6
0.4	10	10	9
0.2	12	8	15
0.1	4	6	20

An investor interested in 2 portfolios as follows:
A_1 A_2 and A_2 A_3

Required:

(i) Calculate the expected absolute risk (standard deviation) on each asset.

(ii) Calculate the correlation coefficient of returns on portfolio A_1 A_2 and A_2 A_3.

(iii) Calculate the absolute risk for each portfolio.

(iv) Recommend the best portfolio on the basis of relative risk i.e coefficient of variation. [12 Marks]

(c) Kenol Ltd is considering acquiring Gulf Ltd. Selected financial data for the two companies are as follows:

	Kenol	Gulf
Annual sales (millions)	Sh. 350	Sh.45
Profit before tax (sh. Million)	28.13	3.775
Ordinary shares (millions)	7.5	1.5
EPS	Sh. 3.75	Sh.2.5
Dividend per share	Sh. 1.3	Sh.0.6
Total market capitalization (millions)	Sh. 420	Sh.45

Required: calculate

(i) The pre-merger market value per share for both companies. [2 Marks]

(ii) The premium paid by Kenol Ltd. [2 Marks]

(iii) Post merger EPS and P/E ratio. [4 Marks]

(iv) Post merger total market capitalization. [2 Marks]

(d) Describe five tactics that a target company may use to defend itself from a hostile takeover. [5 Marks]

QUESTION TWO (20 MARKS)

(a) Distinguish between a financial lease and an operating lease. [4 Marks]

(b) A company is to make a decision whether to lease or buy a new equipment for use in the business. The cost of the equipment is Ksh.1400000 and it has an estimated useful life of five years. Due to high production runs the equipment is likely to do in this period, there is no estimated residual value. Assume that tax is payable at 31% on operating cash flows one year in arrears. Capital allowances of 25% on a reducing balance basis are given on the equipment under a finance agreement for five years at an annual cost of Ksh. 320,000 payable at the end of the year. If the company were to purchase the equipment, it would need to borrow the full amount at 12% interest. Which is the most cost effective option? [11 Marks]

(c) In relation to sources of company finance, explain the following terms;

(i) Rights issue

(ii) Bonus issue

(iii) Share repurchases

(v) Mortgage

(vi) Sale and leaseback. [5 Marks]

QUESTION THREE

(a) Explain the steps involved in drafting a financial plan. [6 Marks]

(b) The Tullow oil company would like to see its sales grow at 20% for the foreseeable future. Its financial statements for the current year are presented below:

Income statement (Sh. 000,000)

Sales	32
Costs	28.97
Gross profit	3.03
Taxes	1.03
Net income	2.00
	===
Dividends	1.4
Retained Earnings	0.6
	2.0
	===

Statement of financial position (Sh.000,000)

Current assets	16
Fixed assets	16
Total assets	32
	===
Current debt	10
Long-term debt	4
Total debt	14
Common stock	14
R E	4
Total liabilities and equity	32
	====

The current financial policy of the Tullow Oil Company includes:

Plowback ratio (1-d)	=	0.3
Debt to Equity ratio (L)	=	77.78%
Net profit margin (P)	=	6.25%
Assets –to-sales ratio (T)	=	1

Required:

(i) Determine the Tullow Company's need for external funds next year. [4 Marks]

(ii) Construct a proforma balance sheet for Tulow Oil Company. [6 Marks]

(iii) Suppose the overall capacity utilization of the company currently stands at 90% would it make any difference in the EFN projections determined in (i) above? [4 Marks]

QUESTION FOUR (20 MARKS)

(a) A company's expected annual EBIT is Sh. 100 000. It has Sh. 0.5 million 6% coupon debt. The firm's overall cost capital is 10%.

(i) Determine the current value of the company using Net Operating Income (NOI) approach. [4 Marks]

(ii) Determine the company's overall capitalization rate (WACC). [2 Marks]

(iii) Assume that the firm has decided to raise the amount of debt to Sh. 800, 000 and use the proceeds to retire equity shares. Would you recommend the action? (support your recommendations with relevant workings) [4 Marks]

(b) The arbitrage process is the behavioural foundation of MM thesis on capital structure. The arbitrage process may however fail to bring equilibrium in the capital market for some reasons. Discuss five reasons. [5 Marks]

(c) Explain the pecking order theory of the capital structure as propounded by Myers. [5 Marks]