THE CATHOLIC UNIVERSITY OF EASTERN AFRICA

A. M. E. C. E. A

P.O. Box 62157
00200 Nairobi · KENYA
Telephone: 891601-6
Fax: 254-20-891084
E-mail:academics@cuea.e

MAIN EXAMINATION

MAY – JULY 2011 TRIMESTER

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

REGULAR PROGRAMME

CFI 311: CORPORATE FINANCE

Date: July 2011 Duration: 2 Hours

INSTRUCTIONS: Answer Question ONE and any other TWO Questions

Q1. a) i) A company is evaluating a long-term project to expand its business The expected cash flows from the project and the corresponding Risk Adjustment Factors (R.A.F) are as follows:

Year	0	1	2	3	4	5
R.A.F.	1	0.95	0.8	0.75	0.4	0.3
Cash flows (Sh)	(100,000)	80.000	60,000	40.000	10.000	4,000

The company uses the risk adjusted discount rate approach to adjust for risk. The risk free rate of return is 8% while the risk adjusted discount rate is 12%. Should the project be undertaken?

(7 marks)

ii) What is the risk premium level associated with this project?

(3 marks)

b) A company is evaluating an expansion project which requires Sh. 60m. This project has the same level of risk as the company's existing operations Hence, the cost of capital for the project is the company's overall cost of capital which is 14%. The company can raise the Sh. 60 m in any of the following options.

Option A: All equity capital of Sh. 60m
Option B: Sh. 40 m from equity and Sh. 20m of debt at an annual interest rate of 10%
Option C: Sh. 30 m from equity and Sh. 30 m of debt paying an interest rate of 10% per year.

The company would prefer the option that leads to the lowest weighted average cost of capital.

Required:

i) Using MMII without taxes show that capital structure affects only the cost of equity and has no effect on the weighted average cost of capital. **(8 marks)**

ii) Why does the cost of equity increase as the company uses more debt? **(4 marks)**

c) Distinguish between the following:
i) Primary and secondary markets **(4 marks)**
ii) Residual dividend policy and constant dividend policy. **(4 marks)**

Q2. a) WSG Ltd is considering a public offering of ordinary shares. Its investment banker has informed the company that the retail price will be sh. 18 per share for 600,000 shares. The company will receive Sh. 16.50 per share from the investment bank and will incur Sh. 150,000 in registration, accounting and printing costs.
i) What is the spread on this issue in percentage terms? **(3 marks)**
ii) What are the total expenses of the issue as a percentage of total retail value? **(4 marks)**
iii) What is the return to the investment bank in percentage terms? **(3 marks)**
iv) If the firm wanted to net Sh. 18 million from this issue, how many shares must be sold. **(6 marks)**

b) Giving an example of each distinguish between public offering and private placement of corporate bonds. **(4 marks)**

Q3. As a capital budgeting analyst in your company, you have been requested to evaluate a new investment project. Information provided on this project is as follows:

i) The project (plant equipment) will cost Sh. 4 million and a further Sh. 200,000 on installation and transportation of the equipment.

ii) This project will need the use of an existing piece of land. Instead this land could be sold for Sh. 1 m at the start of the project. No tax is charged on the proceeds from the land sale.

iii) Initial investment in Networking Capital (NWC) amount to Sh. 250,000. Subsequent NWC needs will be 10% of annual sales.

iv) Fixed costs excluding depreciation amount to Sh. 300,000 per year.

v) The project will generate incremental sales revenue of Sh. 3 m, Sh 4m, Sh. 4.5m, and Sh 4 m in years 1 to 4. Variable costs will be 50% of annual sales.

vi) Consultants were paid a fee of Sh. 100,000 to ascertain the feasibility of the project.

vii) The company uses straight line depreciation method. The equipment is expected to have zero salvage value at the end of 4 years.

viii) The company pays corporate tax rate at 30%, while capital gains or losses are taxed at 25%.

ix) The firm's overall cost of capital is 24%.

Required:

a) Calculate the relevant initial investment outlay. **(4 marks)**

b) Calculate the relevant operating cash flows per year. **(7½ marks)**

c) Calculate the total cash flows per year **(4½ marks)**

d) Should the project be accepted using NPV? **(4 marks)**

Q4. a) With a relevant example each distinguish between crown jewel and white knight as defensive tactics. **(4 marks)**

b) Shareholders of CIC Ltd want to acquire Urem Ltd and subsequently merge their operations. Both firms operate in the local private equity industry. The shareholders of the two companies have just began negotiations CIC Ltd has 40 million shares currently selling at Sh. 20 per share. The company's cost of capital is 10%. Urem Ltd has 35 million shares currently selling Sh. 15 each.

The estimated synergies expected form the acquisition have been currently value at Sh. 100 million.

Shareholders of Urem Ltd, will make a final decision based on the mode of payment by CIC ltd. The price indicated by shareholders of Urem Ltd ~~The price indicated by shareholders of Urem ltd is Sh. 17.50 per share~~. This price can be paid through cash or by shares of CIC Ltd.

Required:

If payment is by cash calculate:

i) The acquisition premium **(2 marks)**

ii) The NPV to CIC Ltd. **(6 marks)**

c) If payment is by shares of CIC Ltd:

i) How many shares will CIC Ltd need to issue? **(2 marks)**

ii) Calculate the NPV to CIC Ltd. **(3 marks)**

Present Value Factors

1) For a single amount = $(1 + r)^{-n}$

2) For an Annuity = $\frac{1-(1+r)^{-n}}{r}$

END