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.edu

LANGATA CAMPUS

MAIN EXAMINATION

MAY - JULY 2013 TRIMESTER

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

REGULAR PROGRAMME

CFI 311: CORPORATE FINANCE

DATE: JULY 2013	DURATION: 2 Hours
INSTRUCTIONS: Answer Question ONE and any other TWO Questions	

Q1. a) Discuss the key finance functions for a financial manager. **(8 marks)**

b) Crystal company Limited has a total capitalization of Ksh. 10,000,000 and it normally earns Ksh. 1,000,000 before interest and taxes. The Financial Manager of the firm wants to take a decision regarding the capital structure. After a study of the capital market, she gathers the following data.

Amount of debt (Ksh)	Interest rate (%)	Equity capitalization rate (%)
0	-	10.00
1,000,000	4.00	10.50
2,000,000	4.00	11.00
3,000,000	4.50	11.60
4,000,000	5.00	12.60
5,000,000	5.50	12.40
6,000,000	6.00	13.50
7,000,000	8.00	20.00

Required:

i) Determine the amount of debt that should be employed by the firm if the traditional approach is held valid. **(10 marks)**

ii) What assumptions have you made in the calculation in (i) above. **(3 marks)**

c) Discuss the importance of capital budgeting decisions to a firm. **(5 marks)**

d) Discuss the any **two** reasons for mergers. (4 marks)

Q2. a) Discuss any three long-term debt financing instruments. (9 marks)

b) A company negotiates a Sh. 20 million loan for ten years from a financial institution. The interest rate is 18% per annum on outstanding balance of the loan. The loan will be repaid in 8 equal year – end installments.

Required:

Prepare a loan repayment schedule. (11 marks)

Q3. Pinnacle Stores Ltd is considering a new product line to supplement its product range line. It is anticipated that the new line will involve cash investment of Sh. 700,000 at time O and Sh. 1,000,000 in year one. After tax cash inflows of Sh. 250,000 are expected in year two, Sh. 300,000 in year three, Sh. 350,000 in year four, and Sh. 400,000 each year thereafter through year ten. Though the product line might be viable after year ten, the company prefers to conserve and end all calculations at that time. The required rate of return is 15%.

Required:

a) What is the net present value of the project? Is the project acceptable? (10 marks)

b) The internal rate of return. Is the project acceptable? (10 marks)

Q4. a) Company A and B are identical in every aspect except that company A is geared while B is not. Company A has 6 million in 5% bonds outstanding. Both companies earn 10% before interest and taxes on their 10 million total assets. Assume perfect capital markets, rational investors, a tax rate of 40% and a capitalization rate of 10% for an all equity company.

Required:

i) Value of the firms A and B using the net income approach (NI) and the net operating income (NOI) approach. (8 marks)

ii) The after tax weighted average cost of capital for each firm using the NOI approach. (6 marks)

b) State **two** short comings of the MM proposition. (2 marks)

c) Outline any **four** assumptions of dividend policy. (4 marks)

END