



THE CATHOLIC UNIVERSITY OF EASTERN AFRICA

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MAIN EXAMINATION

AUGUST - DECEMBER 2010

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

CFI 311: CORPORATE FINANCE

Date: December 2010	Duration: 2 Hours
Instructions: Answer Question ONE and any other TWO	

Q1. a) Tel Ltd is financed by 100% Equity with a cost of equity of 20%. Bet Ltd is similar to Tel Ltd except that Bet Ltd has a different financing mix comprising of Sh. 300 million debt at an interest rate of 10% p.a. and 25 million ordinary shares currently selling at Sh 20 each.

Required: Using MMII without taxes, calculate

- i) Bet Ltd's cost of equity. (7 marks)
- ii) Bet Ltd's overall cost of capital (4 marks)
- iii) Explain how much of Tel Ltd's risk is attributed to Business risk and how much to financial risk. (3 marks)

*Kc = Business risk
(Kc - Kd) = F - F_{new}*

Firm X is considering two projects whose expected cashflows are as follows:

Period	1	2	3	4	5	6
Project. K	Sh. 70,000	Sh. 88,000	Sh. 90,000	Sh. 95,000	Sh. 97,000	Sh. 99,000
J	Sh. 80,000	Sh. 100,000	Sh. 120,000			

The initial cost of project K is Sh. 220,000 while project J will cost Sh. 150,000. The company uses the Equivalent annual annuity method when assessing projects with different lives. If the cost of capital is 12%, which project should be taken and why? (8 marks)

- c) With an example, explain the difference between money and capital markets. (4 marks)
- d) Giving a relevant example distinguish between leveraged Buyout and Divestiture. (4 marks)

Q2. The Bigbee Bottling company is contemplating the replacement of one of its bottling machine with a newer and more efficient one. The old machine has a

sell - bought = original value

book value of Sh. 600,000 and a remaining useful life of 4 years. The firm does not expect to realize any return from scrapping the old machine in 4 years, but it can sell it today to another firm at Sh. 350,000. Additional information on the project is as follows:

- i) The new machine has a purchase price of Sh. 1,180,000 an estimated life of 4 years and an estimated salvage value of Sh. 150,000. The installation cost relating to the new machine amounts to Sh. 170,000.
- ii) The new machine's greater efficiency will result in labour cost savings of Sh. 250,000 per year. Further, sales revenues will increase by Sh. 150,000 per year. Insurance costs relating to the new machine will be Sh. 100,000, Sh. 200,000, Sh. 260,000 and Sh. 200,000 in years 1 to 4 respectively.
- iii) Initial net working capital needed for the new machine is Sh. 50,000. Subsequently, the NWC level will be Sh. 60,000, Sh. 65,000, Sh. 69,000 and Sh. 63,000 in years 1 to 4, respectively.
- iv) The company uses straight - line method to depreciate its fixed assets.
- v) Consultants assessing the feasibility of the new machine have already been paid an amount of Sh. 100,000.
- vi) The firm pays corporate tax at 30%, while any capital gains or losses are charged at 25%.
- vii) The relevant cost of capital is 10%.

depreciation = original value - Book value

Required:

- a) Calculate the relevant initial investment outlay. (5 marks)
- b) Calculate the operating cashflows in years 1 to 4. (7 marks)
- c) Calculate the total cashflow per year for this project. (5 marks)
- d) Using NPV method, should the firm buy the new machine? Support your answer. (3 marks)

Q3. a) Giving an example of each distinguish between a Conglomerate and a Horizontal merger. (4 marks)

M&A (b) SG Ltd is about to acquire OM Ltd and merge the operations of the two firms, since they operate both in the advertising industry. You are a financial analyst in the M&A department of IBC capital, a local investment banking firm operating in the country. You have been asked to assess and analyse this potential M&A deal. Following information is provided:

revenue / saving
expense

	SG Ltd	OM Ltd
Cost of capital	8%	10%
No. of ordinary share outstanding	20 million	10 million
Cash flows after tax	Sh. 16 million	Sh. 5 million

The above cash flows will be generated every year till infinity. The estimated synergies are valued at Sh. 20 million currently. It is assumed that these synergies will be generated by OM Ltd.

4 yrs - 8
800m / 8 p.a

Required:

- i) Calculate the exchange ratio without synergies. (7½ marks)
- ii) If OM Ltd benefits from synergies, calculate the exchange ratio (4½ marks)
- iii) What is the highest price that SG Ltd should be willing to pay in monetary terms and why? (2 marks)
- iv) If the above acquisition was a hostile one, how would OM Ltd use white knight as a defensive mechanism. (2 marks)

Q4. You have just graduated, and have been hired to work in the investor relations department of CLEM Ltd. The company is quoted in the local stock exchange with 10 million shares outstanding. You have been requested to respond to a letter of Anna, a shareholder who holds 20% of the shares of CLEM Ltd. Ms. Anna would like to know if the company will pay any dividends in the coming year. You do not know the company's dividend payment history but you are availed the following:

- i) CLEM Ltd has always adopted a residual dividend policy.
- ii) CLEM Ltd capital structures is made up 20% Debt and 80% equity.
- iii) The company expects to generate net profits amounting to Sh. 16 million in the coming year.

Required:

- a) What is the difference between a constant dividend policy and a constant payout ratio dividend policy? (2 marks)
- b) If the capital structure is to be maintained, calculate the maximum funds available. ^{20%} (4 marks)
- c) If the capital budget for the coming year is Sh. 15 million, will the company pay any dividends? If yes, calculate the dividend per share. ^{100%} (6 marks)
- d) What is the dividend payout ratio in (c) above? ^{100%} (3 marks)
- e) How much dividends will Ms. Anna receive? ^{400,000} (3 marks)
- f) How much is the actual borrowing required in (c) above? ^{3m} (2 marks)

Formulare: Present value interest factors

- 1. For a single amount = $(1+r)^{-n}$
- 2. For an annuity amount = $\frac{1-(1+r)^{-n}}{r}$

Where: r = effective discount rate
n = effective no. of discounting periods

END

$$ER = \frac{T}{B}$$

$$i \quad \frac{5}{0} = \frac{16}{5} = 3.2:17$$

$$ii \quad 5 + 20 = 25$$

$$\frac{25}{16} = 1.5:10$$

Ms.
G = ... = 20
D = ...