MASENO UNIVERSITY

UNIVERSITY EXAMINATIONS 2012/2013

SECOND YEAR SECOND SEMESTER EXAMINATIONS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION (CITY CAMPUS)

MBA 823: CORPORATE FINANCE

Date: 27th July, 2013 *Time: 2.00 – 5.00 p.m.*

INSTRUCTIONS:

1. Answer ANY FOUR questions.
2. All questions carry equal marks.
3. Show all your workings.
4. Do not write on the question paper.

QUESTION ONE

(a) X Ltd. is contemplating a complete share acquisition of Y Ltd. X Ltd. is offering 3 of its shares for every 2 shares of Y Ltd. The data relating to the two companies are shown below:

	X Ltd;	**Y Ltd.**
Earnings	Kshs.5,190,360.00	Kshs 2,340,000.00
Earnings per share (EPS)	14.80	29.25
Market price per share (MPS)	222.00	322.00

Required:

(i) Determine the effect of the acquisition of each company's earnings per share. **(4 marks)**

(ii) Given that the growth rate of X Ltd. is 8% while that of Y Ltd. is 12%. Compute the combined growth rate of two companies. **(2 marks)**

(b) (i) Identify and explain four reasons why a company may wish to take over another company. **(4 marks)**

(iii) Briefly explain five defensive tactics a targeted firm may employ to resist an unwelcome bid. **(5 marks)**

QUESTION TWO

(a) Distinguish between decision tree analysis and simulation analysis **(4 marks)**

(a) An investor has identified a three-year project whose cash inflows and probabilities are estimated as follows:

Year	**Cash inflows (Kshs)**	**Probability**
1	4,000,000	0.5
	5,000,000	0.4
	6,000,000	0.1
2	8,000,000	0.2
	7,000,000	0.3
	6,000,000	0.5
3	12,000,000	0.1
	9,000,000	0.6
	10,000,000	0.3

Additional information:

1. All the cash inflows are expected to occur at the year end.
2. The cost of the project will be Kshs.20 million of which Kshs.18 million will be incurred at the commencement of year 1 and Kshs.2 million will be incurred at the commencement of year 3.
3. The cost of capital is 10%.

Required:

- **(i)** Prepare a decision tree of the project. **(2 marks)**
- **(ii)** Calculate the net present value of the project. **(4 marks)**
- **(iii)** Determine the standard deviation of the project's cash inflows. **(5 marks)** (Hint: first compute the standard deviation for each year).

QUESTION THREE

Appex Limited is considering investing in a new milk cooling plant. The following estimates have been provided to the company's financial analyst about the project.

1. An initial capital outlay of Kshs7 million is required for the purchase of the machine.
2. The machine has an estimated economic life of 5 years.
3. The estimated annual sales volume is 1,000,000 units.
4. The selling price per unit is Kshs14.
5. A variable cost per unit of Kshs 11.
6. Annual fixed costs excluding depreciation of Kshs1 million.
7. A required rate of return of 10%.
8. Tax rate 30%.

Required:

Undertaken a break-even sensitivity analysis on the bases of:

- (i) Initial capital outlay, **(3 marks)**
- **(ii)** Sales volume and, **(6 marks)**
- **(iii)** Variable cost. **(6 marks)**

QUESTION FOUR

(a) Distinguish between bond refunding and bond redemption. **(2 marks)**

(b) Pesa Holdings Ltd. issued a Kshs.10, 000,000, 16% 10 year bond, 5 years ago at a 2% discount. Issuing costs amounted to Kshs 200,000 However, the treasury bills rate has fallen leading to a fall in the interest rates in the market and the financial analyst has proposed that a new Kshs 10,000,000, 12% , 5 year bond be issued at a 3% discount. It is estimated that issuing costs will amount to 5% of the par value.

The old bond can be redeemed at a 10% premium. There will be an interest overlap for two months.
Tax rate is 40%.

Required:

(i) Annual cash investment required for refunding the bond. **(6 marks)**
(ii) Annual cash benefit for refunding the bond **(5 marks)**
(iii) Is it economical to refund the bond? **(2 marks)**

QUESTION FIVE

(a) Discuss the Modigliani and Miller's (MM) dividend irrelevancy proposition. **(7 marks)**

(b) The management of Vikes Ltd. is in the process of evaluating the company's dividend policy.

The following information is provided:

1. The company paid Ksh.1.2 million as dividends in the last financial year.
2. The profit after tax for the last financial year was Ksh.3.6 million.
3. The company has not issued any preference shares
4. The earnings growth rate has been consistent at 10% per annum for the past ten years.
5. The expected profit after tax for the current financial year is Ksh.4.8 million.
6. The company anticipates investment opportunities worth Ksh.1.4 million in the current financial year.
7. The capital structure of the company consists of sixty per cent equity and forty per cent debt.

Required:

Determine the optimal total dividends for the current financial year if the company wishes to adopt each of the following independent dividend policies.

i) Pure residual policy. **(2 marks)**

ii) Constant payout ratio policy **(2 marks)**

iii) Stable predictable dividend policy, the growth rate being equivalent to the earnings growth rate. **(2 marks)**

iv) Regular plus extra dividend policy. The regular dividends would be based on the long run growth rate of earnings while the extra dividends would be based on the residual income. **(2 marks)**

QUESTION SIX

"Creation of shareholder value has become a generally accepted corporate objective. To facilitate the realization of this objective, value based management systems (VBMs) which integrate finance theory and strategic management thinking have been developed by scholars".

Required:

i) Discuss six factors that have stimulated the increased interest by companies in value based management systems. **(9 marks)**

ii) What forces or mechanisms might serve to reduce potential conflicts between management and shareholders? **(6 marks)**