UNIVERSITY OF KABIANGA

UNIVERSITY EXAMINATIONS
2016/2017 ACADEMIC YEAR
THIRD YEAR SECOND SEMESTER EXAMINATION

FOR THE DEGREE OF
BACHELOR OF BUSINESS MANAGEMENT

COURSE CODE: **BBM 314**

COURSE TITLE: **CORPORATE FINANCE**

DATE: 22ND JUNE, 2017 **TIME: 2.00 P.M - 5.00 P.M.**

INSTRUCTIONS TO CANDIDATES

- SEE INSIDE

THIS PAPER CONSISTS OF (4) PRINTED PAGES

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MAIN CAMPUS

UNIVERSITY OF KABIANGA

SCHOOL OF BUSINESS AND ECONOMICS

FIRST SEMESTER EXAMINATIONS-2016/2017 MAIN EXAMS

BBM 314: CORFORATE FINANCE

INSTRUCTIONS TO CANDIDATES: ANSWER ALL QUESTIONS IN SECTION A AND ANY THREE QUESTIONS IN SECTION B.

SECTION A

QUESTION ONE

(a) ABC Ltd has a net operating income of Kshs. 2,000,000 on an investment of Kshs. 10,000,000 in assets. It can raise debt capital at the interest rate of 16%. Assuming that taxes do not exist, using the net income (NI) approach and an equity capitalization rate of 18%, compute the total market value of the firm and its weighted average cost of capital(WACC) if the firm has;

(i) No debt
(ii) Kshs. 3,000,000 debt
(iii) Kshs. 6,000,000 debt (6mks)

(b)Using the net operating income(NOI) approach and an overall capitalization rate of 12%, compute the total value of the firm if the firm has:

(i)No debt

(ii)Kshs. 3,000,000 debt

(iii)Kshs. 6,000,000 debt (6mks)

(c)What is your conclusion about the two approaches in (a) and (b) above. (1mk)

(d)Explain the differences between capital structure and financial structure.(4mks)

(e)Describe the three theories that attempt to explain the relationship between cost of capital structure valuation of the firm. (4mks)

(f)Explain the main features of an optimal capital structure.(4mks)

SECTION B

QUESTION TWO

The Kenya Government recently issued a 12% coupon bond with a 30-year maturity and with a par value of Kshs. 1,000. Find the current price of the bond if yield to maturity is (i)10% (ii)12% (iii) 15% (6mks)

What do you perceive as the relationship between interest rates and value of bond? (2mks)

(b)A coupon bond is currently selling at Kshs. 1250,It has a 20-year maturity and face value of Ksh.1000.

What is the yield to maturity of this bond? (3mks)

(c)Explain the advantages of Euro-markets. (4mks).

QUESTION THREE

(a)The following data pertains to summarized information on the performance of company ABC Ltd

-as a growth firm, normal firm and declining firm.

-Internal rate of return is 15%,10% and 8%

-Capitalization rate is 10% for the three growth stages

-Earnings per share(EPS) are Ksh.20 under the three stages

Determine the market price per share of the company under the three growth stages under both Gordon's and Walter's model under payout ratios of 0%,50% and 100%. (9mks)

(b)From your above calculations, what is the optimal dividend policy of the firm under the three growth stages of the company. (3mks)

(c)Explain the assumptions of MM model. (3mks)

QUESTION FOUR

(a) Suppose Kabianga corporation has decided in favor of capital restructuring that involves increasing its existing Kshs.80 million in debt to Kshs.125 million. The interest rate on the debt is 9% and is not expected to change. The firm currently has 10 million shares outstanding and the price per share is Kshs.45. If the restructuring is expected to increase the ROE, what is the minimum level for EBIT that Kabianga's management must be expecting? Ignore taxes in your answer. (5mks)
(b) Describe the three theories that attempt to explain the relationship between cost of capital structure valuation of the firm. (4mks)
(c) Explain the main features of an optimal capital structure(3mks)

(d) Provide practical considerations in establishing an optimal capital structure(3mks)

QUESTION FIVE

(a)Explain the implications of MM proposition II with taxes (2mks)

(b)Why should financial managers choose the capital structure that maximizes the value of the firm? (4mks)

(c)Tool Manufacturing has an expected EBIT of sh.45, 000 in perpetuity and a tax rate of 35%. The firm has sh.80, 000 in outstanding debt at an interest rate of 9% and its unlevered cost of capital is 14%

(i)What is the value of the firm according to MM proposition I with taxes? (3mks)

(ii)What is it cost of equity? (3mks)

(iii)What is its weighted average cost of capital? (3mks)

QUESTION SIX

(a)Discuss three models on the relevance of dividend policy share of thought.(6mks)

(b)Explain the practical considerations in establishing a stable dividend policy. (4mks)

(c) Outline the chronology of dividend payment. (5mks)