

MAASAI MARA UNIVERSITY

**REGULAR UNIVERSITY EXAMINATIONS**

**2018/2019 ACADEMIC YEAR**

***THIRD YEAR* *FIRST* SEMESTER**

**SCHOOL OF BUSINESS AND ECONOMICS**

**BACHELOR IN SCIENCE IN FINANCIAL ECONOMICS**

**COURSE CODE: ECO 3110**

**COURSE TITLE: CORPORATE FINANCE**

**DATE: 3ND DECEMBER 2018 TIME: 11AM TO 1PM**

**INSTRUCTIONS TO CANDIDATES**

1. Answer Question **ONE** and any other **THREE** questions
2. Question one is **compulsory** and it carries 25 marks **other** questions are 15 marks each

*This paper consists of* ***four*** *printed pages. Please turn over.*

**Question one**

1. Discuss how agency theory explains the relationship between the management and shareholders of a corporation.**(5 marks)**

(b) How is wealth maximization as a goal of the corporate firm consistent with agency theory? **(6 marks)**

(c) Is it true under agency theory that a corporate manager will always undertake projects with positive net present value, under conditions of no capital rationing? Explain. **(6 marks)**

d) Consider two investments, A and B each having the following investment characteristics;

|  |  |  |
| --- | --- | --- |
| **INVESTMENT** | **EXPECTED RETURN (%)** | **PROPOTION** |
| **A** | **10** | **2/3** |
| **B** | **20** | **1/3** |

**REQUIRED:**

Compute the expected return of a portfolio of the two assets. **(4 marks)**

d) Differentiate between bonds and debentures. **(4 marks)**

**Question two**

1. Discuss five factors to be considered when making capital structure decisions **(5 marks)**
2. Bidii limited has a cost of capital of 10%. The company currently has 250,000 shares outstanding and selling on the stock exchange at sh 120 per share. The companys earning per share is sh.10 and intends to maintain a dividend payout ratio of 50% at the end of the current financial year. The companys expected income for the current year is sh. 3million and the available investment proposals are estimated at cost sh. 6 million.

**Required**: Using the Modigliani and Miller model, show that the payment of dividends does not affect the value of the firm. **(10 marks)**

**Question three**

Companies U and L are identical in every respect except that U is unlevered while L has Sh 10 million of 5% bonds outstanding. Assume

(a) That all of the MM assumptions are met

(b) That there are no corporate or personal taxes

(c) That EBIT is Sh 2 million

(d) That the cost of equity to company U is 10%

**Required:**

1. Determine the value MM would estimate for each firm **(4 marks)**
2. Determine the cost of equity for both firms **(4 marks)**
3. What is the overall cost of capital for both firms? **(3 marks)**
4. Suppose the value of U is Sh 20 million and that of L is Sh 22 million. Explain the arbitrage process for a shareholder who owns 10% of company L's shares. **(4 marks)**

**Question four**

1. Define the word time value of money and describe its relevance in finance **(3 marks)**
2. Suppose you want to buy a house in 5 years from now and estimate that the initial down payment of Sh. 2 million will be required at that time. You wish to make equal annual end of year deposits in an account paying annual interest of 6%. Determine the size of the annual deposit. **(6 marks)**
3. Discuss three legal procedures that one firm can use to acquire another firm **(6 marks)**

**Question five**

Bhasmati Rise Company is considering two mutually exclusive projects requiring an initial outlay of shs. 100,000 each and with a useful life of 5 years. The company required rate of return is 10% and the appropriate corporate tax rate is 50%. The project will be depreciated on a straight line basis. Before taxes and depreciation cash flows expected from the projects are as below:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Year |  | 1 | 2 | 3 | 4 | 5 |  |
| Project I | shs. | 40000 | 40000 | 40000 | 40000 | 40000 | | |
| Project 2 | shs. | 60000 | 30000 | 20000 | 50000 | 50000 | | |

Required

1. Compute the after tax cash flows of both projects. **( 3 Marks)**
2. Calculate for each project
3. Net present value **(5 marks)**
4. Internal Rate of Return **(5 marks)**
5. Which project should be accepted and why **(2 marks**