

CHUKA



UNIVERSITY

UNIVERSITY EXAMINATIONS

RESIT/SPECIAL EXAM

**EXAMINATION FOR THE AWARD OF DEGREE
OF BACHELOR OF COMMERCE**

BCOM 332: CORPORATE FINANCE

STREAMS: BCOM (Y3S1)

TIME: 2 HOURS

DAY/DATE: WEDNESDAY 18/11/2020

11.30 A.M. – 1.30 P.M.

INSTRUCTIONS

- 1. Answer Question ONE and any other TWO questions**
- 2. Do not write on the question paper**

QUESTION ONE (30 marks)

- (a) Explain three forms of dividend (6 marks)
- (b) Distinguish between operating and financing lease. (6 marks)
- (c) A company expects a net operating income of sh 80000. It has 200000 8% debentures. The equity capitalization rate of the company is 10%.
- i. Calculate the value of the firm and the overall capitalization rate according to the NI approach (3 marks)
 - ii. If debenture debt is increased to sh 300000 what shall be the value of the firm (3 marks)
- (d) Lyco Company Ltd currently has no debt. Its earnings before interest and tax stand at sh. 3 million. If Lyco decides to use debt, it can borrow sh. 10 million at 8% p.a. The amount raised would be used to retire common stock hence the assets would remain constant. Shares for companies in this risk class require a return of 12% if no debt is used. Assume initially no taxes and that the assumptions of MM hypothesis hold.
- Find
- (i) The value of unlevered firm (2 marks)

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- (ii) The value of the levered firm (2 marks)
- (iii) Cost of equity of the levered firm (2 marks)
- (iv) The levered firm's weighted average cost of capital (2 marks)

(e) Outline four reasons why shareholders may support a proposal for merger of their firm with another. (4 marks)

QUESTION TWO (20 MARKS)

- (a) Describe the clientele theory of dividends (6 marks)
- (b) State the assumptions of Gordon's relevance dividend model (4 marks)
- (c) The EPS of ABC limited is sh 12. The dividend payout is 60%, return on equity is 14% and the capitalization rate is 15%. Calculate the value of equity share using Gordon's model. (4 marks)
- (d) XYZ currently has 8,000 outstanding shares selling at sh.100 each. The dividend for the current financial year is sh.7 per year. The company expects a net income of sh.69000 and has a proposal of making new investment of sh.160, 000. Show that under M-M hypothesis, the payment of dividend does not affect the value of the firm. The equity capitalization rate for the company is 12%. (6 marks)

QUESTION THREE (20 MARKS)

- (a) Explain the pecking order theory of capital structure (4 marks)
- (b) Explain any four reasons why a company may adopt leasing as a source of long-term financing (4 marks)
- (c) Maxi Ltd. Currently pays a dividend of sh.2 per share and this dividend is expected to grow at 15 percent annual rate for 3 years then at a 12 percent rate for the next 3 years thereafter at at 5 percent rate forever. What value would you place on the equity if 9% rate of return were required? (6 marks)
- (d) A company is considering the lease of equipment which has a purchase price of \$1200. The asset has an estimated useful life of 8 years. As per income tax laws, depreciation is on reducing balance method. The lease rental per year is \$180. Assume that the company's corporate tax rate is 30% and the after tax borrowing rate is 12%.

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- (i) Use Net Advantage of Leasing method to determine whether it is advantageous to lease. (4 marks)
- (ii) What will be NAL if the leasing company will pay for operating costs of \$10 per annum and the asset is estimated to have a salvage value of \$50. The after tax cost of capital is 14%. (2 marks)

QUESTION FOUR (20 marks)

- (a) Distinguish between vertical and horizontal merger (5 marks)
- (b) Sunrise limited is taking over sunset limited. The shareholders of sunset would receive 0.8 shares of sunrise for each share held by them. The relevant data for the two companies is as follows.

	Company A	Company B
Net sales	335000	118000
Profit after tax	58000	12000
Number of shares	12000	3000
Earnings per share	4.83	4.0
Market price per share	30	20
Price earnings ratio	6.21	5.0

Required: calculate the combined

- i. Earnings Per Share (2 marks)
 - ii. Price Earnings Ratio (2 marks)
 - iii. Market Price Per Share (2 marks)
 - iv. Number of shares (2 marks)
 - v. Total market capitalization (2 marks)
- (c) Describe five factors that generally influence the dividend policy of a firm (5 marks)
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