

CHUKA



UNIVERSITY

## UNIVERSITY EXAMINATIONS

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

## BCOM 332: CORPORATE FINANCE

STREAMS: ODEL

TIME: 2 HOURS

DAY/DATE: THURSDAY 13/04/2023

8.30 A.M. –10.30 A.M.

**INSTRUCTIONS**

Answer question ONE and any other two

Q1. a) State and explain five features of an appropriate capital structure (10 marks)

b) Property X and Y are categorized under real estate category. Property X is all equity financed while property Y is financed half way using debt and other half by equity finance. Both properties generated operating profit (EBIT) of sh. 40, 245, 000 annually. This is expected to remain constant each year in perpetuity. Unlike property X which is wholly equity financed, property Y is financed 0.5 by equity and 0.5 by 10% debt of sh. 200, 000,000.

The cost of equity is 12% for both properties and there are no corporation taxes.

Each unit of debt is trading at par.

Required:

Using Net Income (NI) approach calculate:

- i. Value of property X (2 marks)
  - ii. Value of property Y and WACC (Weight Average Cost of Capital) (4 marks)
- c) Explain two ways in which increases investment in corporate social responsibility (CSR) activities might enhance the value of a firm (4 marks)
- d) Distinguish between the following terms
- i) “Sell off” and “Spin off” (2 marks)

- ii) Right issue and bonus issue (2 marks)
- iii) Management “buy out” and management “buy in” (2 marks)
- e) State any four limitations of portfolio theory (4 marks)

Q2. a) Ngao Ltd is considering acquiring Bwiri Ltd. The selected financial data for the two companies are as follows:

	Ngao Ltd	Bwiri Ltd
Ordinary shares outstanding (million)	10	2
Annual sales (sh million)	600	120
Net income (sh. Million)	35	3
Market price per share (MPS) sh	40	15
Earnings per share (EPS) sh	3.5	1.5

Both companies are in the 30% bracket.

Required:

- i. Maximum exchange ratio that Ngao Ltd should agree to if expect no dilution in earnings per share (EPS) (2 marks)
  - ii. Total premium that the shareholder of Bwiri Ltd would receive at the exchange ratio calculated in (i) above (2 marks)
  - iii. Ngao Ltd post acquisition earnings per share (EPS), if the two companies settle on a price of sh. 20 per share (3 marks)
  - iv. Ngao Ltd post acquisition earnings per share if every 50 ordinary shares of Bwiri Ltd were exchanged for one 8% debenture of a par value of sh. 1,000 each. (4 marks)
- b) Evaluate five defensive tactics available to a firm threatened by a hostile takeover in the industry (5 marks)
- c) Briefly describe the following types of merges:
- i. Horizontal (1 marks)
  - ii. Vertical (1 marks)
  - iii. Congeneric (1 marks)
  - iv. Conglomerate (1 marks)

Q3. a) Discuss four reasons for restructuring and reorganization of a an organization (8 marks)

b) The following data relate to Ndovu Ltd a company that operate in the manufacturing sector for the year ended 31<sup>st</sup> Dec 2022.

	Sh '000'
Sales	25, 678
Total assets	49, 579
Total liabilities	5, 044
Retained Earnings	1,770
Net working capital	(1,777)
Earnings before interest and taxes	2,605
Market value of equity	10, 098
Book value of total liabilities	5,044

The company is currently paying interest on a long term debt instrument amounting to sh. 905,000 per year and that the company's total liabilities is constituted in the ratio of 2:5 between current and non-current components.

Required:

Using the springate model, assess the financial health of the company (10 marks)

Note: The springate model take the following forms

$$Z = 1.3A + 3.07B + 0.66C + 0.4D$$

Where:

$$A = \frac{\text{Networking capital}}{\text{Total assets}}$$

$$C = \frac{\text{Net profit before taxes}}{\text{current liabilities}}$$

$$B = \frac{\text{Operating profit}}{\text{Total assets}}$$

$$D = \frac{\text{Sales}}{\text{total assets}}$$

c) Distinguish between “insolvency” and “bankruptcy” as used in the business restricting (2 marks)

Q4. a) The following information has been extracted from the book of XYZ Ltd .

Profit after tax (PAT) 80, 000,000

Number of outstanding shares 1,000,000

Cost of capital 12%

Internal rate of return from investment 14%.

- i. Calculate the market value of the company using Walters Model when dividend payout ratio is:

- a. 30%
- b. 50%
- c. 80% (6 marks)

ii. Commend on the finding in (i) above (2 marks)

iii. Outline the limitations of using Walters Model (3 marks)

b) Consider two firms where one is levered and the other one is unlevered. Both firms have operating profit of sh. 800, 000. The leveled firm has a debt of sh. 4, 000, 000 whose interest rate is 7.5%. Both firms have cost of equity 10%.

Assume that there are no corporate taxes

Required:

- i. Compute the value of levered firm
- ii. Compute the value unlevered firm
- iii. The value of levered firm if tax rate is 40% (6 marks)

c) Describe clientel effect theory (3 marks)

---