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MAIN EXAMINATION

MAY – JULY 2016 TRIMESTER

FACULTY OF COMMERCE

DEPARTMENT OF ACCOUNTING AND FINANCE

REGULAR PROGRAMME

CFI 311: CORPORATE FINANCE

Date: JULY 2016	Duration: 2 Hours
INSTRUCTIONS: Answer Question ONE and ANY OTHER TWO Questions	

Q1. a) Consider the following two projects each with an initial capital of sh 100,000 with the following cash flows

Year	1	2	3
A	70,000	30,000	45,000
B	40,000	50,000	55,000

Required
What project should be accepted on
i Payback period (PBP) and
ii Risk of cashflows as meadured by the standard deviation
(8 marks)

b) Explain ways of solving conflicts between shareholders and management of a firm. **(5 marks)**

c) Distinguish between a horizontal merger and conglomerate **(4 marks)**

d) The capital structure of Kilimo Bora Ltd as at 30/06/2015

	sh 'million'
Ordinary share capital(sh. 20 per share)	400
Retained earnings	200
12% debt	250
10% preference share capital	200
	1050

The corporate tax is 30% and for the year just ended the company reported operating profits of sh 230,000,000. The firm's dividend payout ratio is 40%. The following projections have been made concerning future dividends.

i. There will be no growth in dividend per share (DPS)
ii. DPS increase by 5% p.a in perpetuity. Required rate of return is 15%

Required
Determine the maximum price to pay for share of Kilimo Bora Ltd.
Note: The maximum price to pay for a security represents its intrinsic value / real value and this is given by the sum of present values of the cash flows expected from the security in this case the dividend received.
(13 marks)

Q2. a) Discuss the advantages of leasing as a means of financing. **(5 marks)**

b) DRM Ltd is interested in increasing its overall cost of capital. The firm is in the 40% tax bracket. The following data is provided.

i. The firm can be raised unlimited amount of debt by selling 10% 10 year sh 1000 per debenture. Discount on this bond is sh 30. A floatation cost of sh 20 per debt unit is incurred.

ii. The firm can raise unlimited amount of 11% sh 100 per preference shares. The issue cost is sh 4 per share.

iii. Ordinary shares. The firms are currently selling at sh 80 per share. Expected dividend next year is sh 6. The dividend is expected to grow at 6% p.a. The share will be underpriced by sh 4 and a floatation cost of sh 4 will be incurred. The firm can sell unlimited number of ordinary shares.

iv. Retained earnings: The firm expects to have sh 225,000 of retained earnings in the next year. Once retained earnings is exhausted, the firm will use new common stock.

Required

Calculate the specific cost of each source of finance. (Hint: use the interpolation formula to calculate the cost of debt) **(15 marks)**

Q3. Franchise operators pay sh 900,000 per outlet in addition to the cost of services provided by Timely Horizon Ltd. For the first 10 years, Timely Horizons earns an average of ksh 4.2 million p.a by operating each outlet thereafter the benefits average sh 28 million as sale prices which depend on the type of sale as given below

Year	5	10	15
Sale price	9.5 million	7.0 million	5.2 million

The operating cycle of each outlet is 15 years. It costs the firm sh 6.5 million to build each outlet and its required rate of return is 22%

Required

Determine the optimal sale or abandonment time assuming

i The sale does not free up any resource other than capital

ii The sale of one outlet frees up management time so that another outlet could be put in operation. **(20 marks)**

Q4. a) Explain any FIVE factors that would compel a firm to capital rationing decisions. **(5 marks)**

b) ABC Ltd expects Earnings Before Interest and Tax (EBIT) of sh 100,000 I the current year. If the firm has sh 200,000 bond with a 10% coupon rate of interest and an issue of 60,000 shares of sh 4 annual dividend of 10% preferred stock. It also has 10,000 shares of common stock outstanding. Assume a tax rate of 30%

Required

Calculate EPS for various EBIT of sh 60,000, sh 100,000 and sh 140,000 **(15 marks)**

END