year. The project will be financed at Blue Angel's target debt–equity ratio. Annual cash flows from the project will grow at a constant rate of 5 percent until the end of the fifth year and remain constant forever thereafter. Investigating this situation, comment whether Blue Angel should invest in the project or restrain from it. (CO5)

H

Roll No. ....

MB–204

M. B A. (SECOND SEMESTER) END SEMESTER EXAMINATION, 2021-22

CORPORATE FINANCE

Time : Three Hours

Maximum Marks : 100

Note : (i) This question paper contains two Sections–Section A and Section B.

(ii) Both Sections are compulsory.

(iii) Answer any *two* sub-questions among (a), (b) and (c) in each main question of Section A. Each question carries 10 marks.

(iv) Section B consisting of Case Study is compulsory. Section B is of 20 marks.

Section—A

1. (a) The current price per share is $25. Another company has just announced that it wants

to buy your company and will pay \$35 per share to acquire all the outstanding stock. Your company's management immediately begins fighting off this hostile bid. Based on your understanding, comment whether the management acting in the shareholders' best interests ? Why or why not ? (CO1)

(b) Based on your understanding on Corporations, Comment on the statement "Managers should not focus on the current stock value because doing so will lead to an overemphasis on short-term profits at the expense of long-term profits". (CO1)

(c) Who owns a corporation ? Exemplify the process whereby the owners control the firm's management. What is the main reason that an agency relationship exists in the corporate form of organization ? In this context, what kinds of problems can arise ? (CO1)

2. (a) You are planning to save for retirement over the next 30 years. To do this, you will invest \$800 a month in a stock account and \$350 a month in a bond account. The return of the stock account is expected to be 11 percent, and the bond account will pay 6 percent. When you retire, you will combine your money into an account with an 8 percent return. Implementing the concept of time value of money, calculate the amount you withdraw each month from your account assuming a 25-year withdrawal period ? (CO2)

(b) The Faulk Corp has a 6 percent coupon bond outstanding. The Gonas Company has a 14 percent bond outstanding. Both bonds have 12 years to maturity, make semiannual payments, and have an YTM of 10 percent. If interest rates suddenly rise by 2 percent, what is the percentage change in the price of these bonds ? What if interest rates suddenly fall by 2 percent instead ? Attributing the problem to interest rate risk of lower coupon bonds ? (CO3)

(c) Suppose you know that a company's stock currently sells for \$72 per share and the required return on the stock is 11.5 percent. You also known that the total return on the stock is evenly divided between a capital gains yield and a dividend yield. If it's the company's policy to always maintain a constant growth rate in its dividends, evaluate the current dividend per share. (CO4)

3. (a) Consider a levered firm's project that have similar risks to the firm as a whole. Illustrate whether the discount rate for the projects is higher or lower than the rate computed using the security market line ? Why ? (CO2)

(b) Advance, Inc. is trying to determine its cost of debt. The firm has a debt issue outstanding with 17 years to maturity that is quoted at 95 percent of face value. The issue makes semiannual payments and has a coupon rate of 8 percent annually. Solve the Advance's Inc. pretax cost of debt ? If the tax rate is 35 percent, what is the after-tax cost of debt ? (CO2)

(c) Rolston Corporation is comparing two different capital structures, an all-equity plan (Plain I) and a levered plan (Plan II). Under Plan I, Rolston would have 265,000 shares of stock outstanding. Under Plan II, there would be 185,000 shares of stock outstanding and \$2.8 million in debt outstanding. The interest rate on the debt is 10 percent and there are no taxes. (CO3)

(i) If EBIT is \$750,000, which plan will result in the higher EPS ?

(ii) If EBIT is \$1,500,000, which plan will result in the higher EPS ?

(iii) What is the break-even EBIT ?

4. (a) You are evaluating, whether your company should undertake a new project and have calculated the NPV of the project using the WACC method when the CFO, a former accountant, notices that you did not use the interest payments in calculating the cash flows of the project. What should you

tell him ? If he insists that you include the interest payments in calculating the cash flows, what method can you use ? (CO4)

(b) If Wild Widgets, Inc., were an all-equity company, it would have a beta of .85. The company has a target debt. equity ratio of .40. The expected return on the market portfolio is 11 percent, and Treasury bills currently yield 4 percent. The company has one bond issue outstanding that matures in 20 years and has a coupon rate of 7 percent. The bond current sells for $1,080. The corporate tax rate is 34 percent. Differentiate the outcomes under these conditions. (CO3)

(i) What is the company's cost of debt ?

(ii) What is the company's cost of equity ?

(iii) What is the company's weighted average cost of capital ?

(c) You own 1,000 shares of stock in Avondale Corporate. You will received a dividend of $1.10 per share in one year. In two years, Avondale will pay a liquidating dividend of $56 per share. The required return on Avondale stock is 14 percent. What is the current share price of your stock (ignoring taxes) ? If you would rather have equal dividends in each of the next two years, show how you can accomplish this by formulating homemade dividends. (CO4)

Section—B

5. **Case Study :** (20 Marks)

Blue Angle, Inc., a private firm in the holiday gift industry, is considering a new project. The company currently has a target debt–equity ratio of 0.40, but the industry target debt-equity ratio is 0.35. The industry average beta is 1.2. The market risk premium is 7 percent, and the risk-free rate is 5 percent. Assume all companies in this industry can issued debt at the risk-free rate. The corporate tax rate is 40 percent. The project requires an initial outlay of $675,000 and is expected to result in a $95,000 cash inflow at the end of the first