**LAIKIPIA UNIVERSITY COLLEGE**

**NAIVASHA CAMPUS**

BCOM 332: TAKE AWAY CAT

1. Keroche Enterprises has never paid a dividend. Free cash flow is projected to be Ksh.80, 000 and Ksh.100, 000 for the next 2 years, respectively; after the second year, FCF is expected to grow at a constant rate of 8%. The company’s weighted average cost of capital is 12%.

a. What is the terminal, or horizon, value of operations? (Hint: Find the value of all free cash flows beyond Year 2 discounted back to Year 2.) (4 mks)

b. Calculate the value of Keroche’s operations. (4 mks)

2. Components Manufacturing Corporation (CMC) has 1 million shares of stock outstanding. CMC has a target capital structure with 60% equity and 40% debt. The company projects net income of Ksh.5 million and investment projects requiring Ksh.6 million in the upcoming year.

a. CMC uses the residual distribution model and pays all distributions in the form of dividends. What is the projected DPS? (2 mks)

b. What is the projected payout ratio? (2 mks)

3. Mjengo plc is a property development company operating in the London area. The company has the following capital structure as at 30 November 2011:

**Ksh.000**

Ksh.1 ordinary shares 10,000

Retained profit 20,000

9% debentures 12,000

42,000

The equity shares have a current market value of Ksh.3.90 per share and the current level of dividend is 20 Cents per share. The dividend has been growing at a compound rate of 4 per cent per annum in recent years. The debentures of the company are irredeemable and have a current market value of Ksh.80 per Ksh.100 nominal. Interest due on the debentures at the yearend has recently been paid. The company has obtained planning permission to build a new office block in a redevelopment area. The company wishes to raise the whole of the finance necessary for the project by the issue of more irredeemable 9 per cent debentures at Ksh.80 per Ksh.100 nominal. This is in line with a target capital structure set by the company where the amount of debt capital will increase to 70 per cent of equity within the next two years. The rate of corporation tax is 25 per cent.

**Required**

**(a)** Explain what is meant by the term ‘cost of capital’. Why is it important for a company to calculate its cost of capital correctly?

**(b)** What are the main factors which determine the cost of capital of a company?

**(c)** Calculate the weighted average cost of capital of Mjengo plc which should be used for future investment decisions.

4. As a defense against a possible takeover bid the managing director proposes that Woppit make a bid for Grapper plc, in order to increase Woppit’s size and, hence, make a bid for Woppit more difficult. The companies are in the same industry. Woppit’s equity Beta is 1.2 and Grapper’s is 1.05. The risk-free rate and market return are estimated to be 10 and 16 per cent p.a. respectively. The growth rate of after-tax earnings of Woppit in recent years has been 15 per cent p.a. and of Grapper 12 per cent p.a. Both companies maintain an approximately constant dividend payout ratio. Woppit’s directors require information about how much premium above the current market price to offer for Grapper’s shares. Two suggestions are:

**(i)** The price should be based upon the Balance Sheet net worth of the company, adjusted for the current value of land and buildings, plus estimated after tax profits for the next five years.

**(ii)** The price should be based upon a valuation using the Dividend Valuation Model, using existing growth rate estimates.

Most Recent balance sheets

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Woppit** | | **Grapper** | |
|  | Ksh. Millions | Ksh. Millions | Ksh. Millions | Ksh. Millions |
| Land and buildings (net) |  | 560 |  | 150 |
| Plant and machinery (net) |  | 720 |  | 280 |
| Stock | 340 |  | 240 |  |
| Debtors | 300 |  | 210 |  |
| Bank | 20 | 660 | 40 | 490 |
| *Less:* Trade creditors | (200) |  | (110) |  |
| Overdraft | (30) |  | (10) |  |
| Tax payable | (120) |  | (40) |  |
| Dividends payable | (150) | (400) | (40) | (200) |
| Total assets *less* current liabilities |  | **1540** |  | **720** |
|  |  |  |  |  |
| **Financed by:** |  |  |  |  |
| Ordinary shares |  | 200 |  | 100 |
| Share premium |  | 420 |  | 220 |
| Other reserves |  | 400 |  | 300 |
|  |  | **1020** |  | 620 |
| Loans due after one year |  | 520 |  | 100 |
|  |  | **1540** |  | **720** |
|  |  |  |  |  |

* Woppit’s land and buildings have been recently revalued. Grapper’s have not been revalued for four years, during which time the average value of industrial land and buildings has increased by 25 per cent p.a.
* Woppit Ksh. 1 par value, Grapper Ksh. 2.50 par value
* The current share price of Woppit is Ksh. 3.10 pence and of Grapper Ksh. 4.70.

**Most recent Profit and Loss accounts**

|  |  |  |
| --- | --- | --- |
|  | **Woppit** | **Grapper** |
|  | **Ksh. Millions** | **Ksh. Millions** |
| **Turnover** | **3500** | **1540** |
| **Operating profit** | **700** | **255** |
| **Net Interest** | **(120)** | **(22)** |
| **Taxable profit** | **580** | **233** |
| **Taxation** | **(203)** | **(82)** |
| **Profit attributable to shareholders** | **377** | **151** |
| **Dividends** | **(113)** | **(76)** |
| **Retained profit** | **264** | **75** |
|  |  |  |

**Required**

**(a)** Calculate the premium per share above Grapper’s current share price that would result from the two suggested valuation methods. Discuss which, if either, of these values should be the bid price. State clearly any assumptions that you make.

**(b)** Assess the managing director’s strategy of seeking growth by acquisition in order to make a bid for Woppit more difficult.

**(c)** Illustrate how Woppit might achieve benefits through improvements in operational efficiency if it acquires Grapper.