LAIKIPIA UNIVERSITY COLLEGE

NAIVASHA CAMPUS

BCOM 332: CORPORATE FINANCE

ATTEMPT QUESTION 1, AND CHOOSE 2 OTHER QUESTIONS

1.

1. Discuss three sources of short term finance, and three sources of long term finance (9 mks)
2. Preference shares do not benefit the organization with a tax shield. Why do corporations still issue preference shares, and not just issue debt? (3 mks)
3. Compute the expected return and risk associated with the following probability distribution of cash flows for a firm A.

|  |  |  |
| --- | --- | --- |
| Cash flow A | Cash Flow B | Probability |
| 10,000 | 3,000 | 0.6 |
| 3,000 | 6,000 | 0.1 |
| 20,000 | 5,000 | 0.3 |

2.

Karuturi plc is a service company that has been listed for six years. Its bank has advised the company’s directors that their proposed 1 for 4 rights issue should be at a 15 per cent discount to their current ordinary share price of Ksh.4.20. The proposed rights issue is for Ksh.3m to expand existing business activities.

a. Mr. Tundra is a small investor who owns 10 000 shares of Freeze plc. Using the information provided, discuss the effect of the proposed rights issue on the personal wealth of Mr Tundra.

b. Critically discuss the factors to be considered by Freeze plc in using a rights issue as a way of raising new equity finance. Your answer should include a discussion of the following points:

(i) The difference between actual and theoretical ex-rights price;

(ii) Other ways in which Freeze plc could raise the new equity finance.

3.

1. Oserian PLC, which pays corporation tax at 30 per cent, has the following capital structure:

* *Ordinary shares*: 1,000, 000 ordinary shares of nominal (par) value Ksh. 25per share. The market value of the shares is Ksh. 49 per share. A dividend of Ksh. 7 per share has just been paid and dividends are expected to grow by 8 per cent per year for the foreseeable future.
* *Preference shares*: 250 000 preference shares of nominal value Ksh. 50 per share. The market value of the shares is Ksh. 32 per share and the annual net dividend of 7.5 per cent has just been paid.
* *Debentures*: Ksh. 100 000 of irredeemable debentures with a market price of Ksh. 92 per Ksh. 100 par. These debentures have a coupon rate of 10 per cent and the annual interest payment has just been made.

Calculate the weighted average after-tax cost of capital of Oserian PLC. (6 mks)

1. Find the WACC of Naivasha Computers. The total book value of the firm’s equity is Ksh.10 million; book value per share is Ksh.20. The stock sells for a price of Ksh.30 per share, and the cost of equity is 15 percent. The firm’s bonds have a par value of Ksh.5 million and sell at a price of 110 percent of par. The yield to maturity on the bonds is 9 percent, and the firm’s tax rate is 40 percent. (8 mks)
2. Discuss the practical issues to be considered by a company when deciding on the size of its dividend payment. (6 mks)

4.

1. Define the following terms:

(a) LBO.

(b) MBO.

(c) Spin-off.

(d) Carve-out.

(e) Asset sale.

(f) Privatization. (12 mks)

1. Firms may choose to merge for a variety of reasons. Discuss 3 sensible motives for merging and at least one dubious reason for mergers. (8 mks)

5.

1. “The firm can’t use interest tax shields unless it has (taxable) income to shield.” What does this statement imply for the debt policy? Explain briefly. (4 mks)

**b.** What are the costs of going bankrupt? Define these costs carefully. (6 mks)

**c.** “A company can incur costs of financial distress without ever going bankrupt.” Explain how this can happen. (6 mks)

**d.** Explain how conflicts of interest between bondholders and stockholders can lead to costs of financial distress. (4 mks)