BUS312: Introduction to Corporate Finance

Assignment #10

Question #1

A firm is about to make either a general cash offer or a rights issue of new common shares. In each case, explain the significance of pricing newly issued shares below current market share price. (Do not use a numerical example to answer this question).

Question #2

A firm has two mutually exclusive projects: the projects are of equivalent risk, and therefore, they have the same discount factor. Hypothetically, if the discount factor were 5% per annum, the NPVs of projects A and B would be $10,000 and $5,000 respectively. On the other hand, if the discount rate were 15%, the NPVs of projects A and B would be $1,000 and $2,000 respectively. What is your best estimate for the IRR for each of these projects (i.e., use a linear approximation to the NPV schedule). Which of these projects should be chosen by the firm?

Question #3

The theory of capital market efficiency implies that the rate of return on a common share must exceed that on interest bearing financial assets because the former is more risky than the latter. Discuss this statement.

Question #4

The predicted earnings per share of ABC company from past investment in business activity is $2 per share. ABC pays dividends once per year and it has just made a dividend payment (i.e., the ex-dividend date is today). Dividend yield (using the dividend predicted in one year) is 5% per annum. Growth in dividends and earnings is predicted to be about 6% per annum into the indefinite future. ABC retains a constant fraction of earnings each year for reinvestment and growth. ABC's price/earnings ratio (using earnings predicted in the upcoming year) is 15.0.

a. What is ABC's pay-out ratio?
b. What is the rate of return on equity?
c. An accounting pal of yours recommends you purchase ABC common shares because they have a high ROE. How do you respond?

d. You (as an investor) have a three year investment horizon. You plan to buy a share of ABC company today, hold it for exactly three years, and sell it immediately after the dividend. With the dividends you receive in the interim, you plan to purchase additional ABC shares (fractional purchase of shares is possible). Dividends received on these shares will also be used to reinvest into the common shares of ABC. You will liquidate all of your ABC shares at the end of your investment horizon (exactly three years from today, immediately after the dividend payment). What annualized holding period rate of return do you expect to receive on your investment plan?

Question #5

Which of the following cases characterizes a bond selling at a discount? You *must* explain your answer in order to be awarded marks for this question.

	Coupon Rate Greater than Current Yield	Current Yield Greater than Yield to Maturity
(a)	yes	yes
(b)	yes	no
(c)	no	yes
(d)	no	no