KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2017/2018

FIRST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF COMMERCE

BAC 308: CORPORATE FINANCE

DATE: Thursday 30th November, 2017 **TIME: 4.30 p.m. - 6.30 p.m.**

INSTRUCTIONS

Answer all the questions

QUESTION ONE (20 MARKS)

ABC Ltd issued a Sh.100 million par value, 10-year 16% bond, five years ago. The bond was issued at a 2 per cent discount and issuing costs amounted to Sh.2 million. Due to the decline in Treasury bill rates in the recent past, interest rates in the money market have been falling presenting favourable opportunities for refinancing. A financial analyst engaged by the company to assess the possibility of refinancing the debt reports that a new Sh.100 million par value, 12 per cent, 5-year bond can be issued by the company. Issuing costs for the new bond will be 5 per cent of the par value and a discount of 3 per cent will have to be given to attract investors. The old bond can be redeemed at 10 per cent premium and in addition, two months interest penalty will have to be paid on redemption. All bond issue expenses (including the interest penalty) are amortised on a straight-line basis over the life of the bond and are allowable for corporate tax purposes.

The applicable corporate tax rate is 40 per cent and the after tax cost of debt to the company is approximately 7%.

Required:

a) Cash investment required for the refinancing decision. (9 marks)

b) Annual cash benefits (savings) of the refinancing decision. (6 marks)

c) i) Net Present Value (NPV) of the refinancing decision. (3 marks)

ii) Is it worthwhile to issue a new bond to replace the existing bond? Explain. (2 marks)

QUESTION TWO (20 MARKS)

a) Explain any **three** forms of capital markets efficiency and how each can be tested (6 marks)

b) "if a capital market is efficient, the security prices follow a random walk and as such, it would be impossible to accurately predict the stock prices, however, research have shown some anomalies which makes security prices predictable, discuss any **four** such anomalies (8 marks)

c) By use of examples explain any three corporate governance tools (6 Marks)

QUESTION THREE (20 MARKS)

a. Explain any **three** advantages of a rights issue both to the issuing company and shareholders 6 Marks

b. Highlight any Two advantages of lease financing 2 Marks

c. The Jambo Company Ltd. has issued 10,000,000, Sh. 10 par equity shares which are at present selling for Sh. 30 per share.

   i. The company has plans to issue rights to purchase one new equity share at a price of Sh. 20 per share for every four shares held.

Required:

1. Calculate the theoretical ex-rights price of Jambo Company Ltd.'s equity shares. (2 mark)
2. The theoretical value of a right of the Jambo Company Ltd before the shares sell ex-rights (2 marks)

   ii. The chairman of the company receives a phone call from an angry shareholder who owns 100,000 shares. The shareholder argues that he will suffer a loss in his personal wealth due to this rights issue, because the new shares are being offered at a price lower than the current market value.The chairman assures him that his wealth will not be reduced because of the rights issue, as long as the shareholder takes appropriate action.

Required:

a) Explain whether the chairman is correct. What should the shareholder do? (2 marks)

b) A statement showing the effect of the rights issue on this particular shareholder's wealth, assuming:

- He sells all the rights.
- He exercises one half of the rights and sells the other half.
- He does nothing at all. (6 marks)

QUESTION FOUR (10 MARKS)

X Ltd intends to take-over Y Ltd by offering two of its share for every five shares in Y Company Ltd. Relevant financial data is as follows:

	X Ltd	**Y Ltd**
EPS	Shs 2	Shs 2
Market price per share	Shs 100	Shs 40
Price earnings ratio	50	20
No. of shares	100,000	250,000
Total earnings	Shs 200,000	Shs 500,000
Total market value	Shs 10,000,000	Shs 10,000,000

REQUIRED:

a. Compute the combined EPS & MPS (6 marks)

b. Has wealth been created for shareholders? (4 marks)