KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

FIRST SEMESTER EXAMINATION FOR THE DEGREE OF MASTER OF ECONOMICS AND FINANCE

EAE 817: CORPORATE FINANCE AND INVESTMENT II

DATE: Tuesday 29th November 2016 **TIME: 2.00p.m -5.00p.m**

INSTRUCTIONS:

1. **Answer ALL Questions**
2. **Each Question carries 15 marks**

QUESTION ONE (15 MARKS)

a) What is an optimal capital structure? [2marks]

b) What is the pecking order theory [3marks]

c) Suppose ABC corporation has decided in favour of a capital restructuring that involves increasing its existing \$80 million in debt to \$125 million. The interest rate on the debt is 9 percent, and is ~~ot~~ not expected to change. The firm currently has 10 million shares outstanding, and the share price is \$45. If the restructuring is expected to increase the Return on Equity (ROE), what is the minimum level for Earning Before Interest & Tax (EBIT) that ABC's management must be expecting? Ignore taxes in your answer. [10marks]

QUESTION TWO (15 MARKS)

a) What are the differences between Eurobond and a foreign bond? [4marks]

b) What is triangle arbitrage? [2marks]

c) According to relative PPP, what determines the change in exchange rates? [2marks]

d) Suppose the exchange rate for the South African rand, S_0, is currently R13.0745 = €1. If the interest rate in the Eurozone is R_{EURO} = 2.12 percent and the interest rate in South Africa is R_{SA} = 10.95 percent, then what must be the forward rate to prevent covered interest arbitrage? [4marks]

e) The inflation rate in the United Kingdom is projected at 3 percent per year for the next several years. The Swiss inflation rate is projected to be 5 percent during that time. The exchange rate is currently SFr1.66. Based on relative PPP, what is the expected exchange rate in two years? [3marks]

QUESTION THREE (15 MARKS)

1. Describe how the Miller-Orr model works. [4marks]
2. How does EOQ model determine for a corporation? [2marks]
3. Given the following information,

Annual interest rate	12%
Fixed order cost	$100
Total cash needed	$240,000

a) Calculate the target cash balance using BAT model. [4marks]

b) Compute the following:

i) The opportunity cost of holding cash. [3marks]

ii) The trading cost [1mark]

iii) The total cost [1mark]

QUESTION FOUR (25 MARKS)

a) Explain the important factors in deciding whether to use equity or cash in an acquisition. [3marks]

b) Firm A and B are competitors with very similar assets and business risks. Both are all-equity firms with the after-tax cash flows of $10 per year forever, and both have an overall cost of capital of 10 percent. Firm A is thinking of buying firm B. The after-tax cash flow from the merged firm would be $21 per year.

i) Does the merger generate synergy? [3marks]

ii) Compute V_B^*

iii) What ΔV? [3marks]

c) Consider the following information fo two all-equity firms, A and B:-

	Firm A	Firm B
Shares outstanding	2,000	6,000
Share per price($)	40	30

Firm A estimates that the value of synergistic benefit from acquiring Firm B is $6,000.

Firm B has indicated that it would accept a cash purchase offer of $ 35 per share. Should Firm A proceed? [3marks]