KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2017/2018

DIGITAL SCHOOL OF VIRTUAL AND OPEN LEARNING

SECOND SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF COMMERCE

BAC 308: CORPORATE FINANCE

DATE: WEDNESDAY 20TH JUNE 2018 **TIME: 11.00 A.M. - 1.00 P.M.**

INSTRUCTIONS:

Question One

Dove Construction Company Ltd issued a Sh.100 million bond 5 years ago when interest rates were substantially high. The interest rates have now fallen and the firm wishes to retire this old debt and replace it with a new and cheaper one. Given below are the details of the two bond issues.

Old Bond: The outstanding bond have a nominal value of Sh.1,000 and 24% coupon interest rate. They were issued 5 years ago with a 15-year maturity. They were initially sold at their nominal value of sh.1,000 and the fir incurred Sh.390,000 in floatation costs. They are callable at Sh.1,120.

New Bond: The new bonds would have a Sh.1,000 nominal value and a 20% coupon interest rate. They would have a 10-year maturity and could be sold at their par value. The issuance cost of the new bonds would be Sh525,000.

Assume the firm does not expect to have any overlapping interest and is in the 35% tax bracket.

Required:

i. Calculate the after-tax cash inflows expected from the unamortized portion of the old bond's issuance cost. (3 marks)

ii. Calculate the annual after-tax cash inflows from the issuance of the new bonds assuming the 10-year amortization. (3 marks)

iii. Calculate the after-tax cash outflow from the call premium required to retire the old bonds. (2 marks)

iv. Determine the incremental initial cash outlay required to issue the new bonds. (5 marks)

v. Calculate the annual cash-flow savings, if any, expected from the bond refunding. (5 marks)

vi. If the firm has a 14% after-tax cost of debt, would you recommend the proposed refunding and reissue? Explain. (2 marks)

(Total 20 marks)

Question Two

a) Explain any **Five** reasons why a company may take a lease as a source of long term financing. (10 marks)

b) Metric Ltd has decided to acquire a piece of equipment costing Kshs.300,000 with a life of five years. The equipment is expected to have no salvage value at the end and the company uses straight-line depreciation method on all its Fixed Assets. The company has two financing alternative methods available, leasing or borrowing. The loan has an interest rate of 15% requiring equal-year-end installments to be paid. the lease would be set at a level that would amortize the cost of equipment over the lease period and would provide the lessor with a 14% return on capital. the company's tax rate is 40%.

Required:

i) Compute the annual lease payments (3 marks)

ii) Compute the PV of the cash out flow under lease financing. (3 marks)

iii) Calculate the annual loan instalment payment. (5 marks)

iv) Advice the company on which alternative is better and why. (1 mark)

(Total 20 marks)

Question Three

a) Explain any **three** forms of market efficiency. (6 marks)

b) Explain any **five** types of market anomalies. (10 marks)

(Total 16 marks)

Question Four

The following information relates to Company Blue and Yellow.

	Company Blue	**Company Yellow**
Present earnings	Kshs 36,000,000	Kshs8,000,000
No. of shares	6,000,000	2,000,000
Earning per share	6.66	6.0
Market price per share	60.00	30.00
Price/earning ratio	16	10

Company Blue offers 0.667 shares for each share of Company Yellow to acquire the company.

Required:

i) Calculate the market price exchange ratio. (4 marks)

ii) Compute the combined EPS after the proposed merger. (4 marks)

iii) Explain the overall effect of the merger assuming that the price earnings ratio remain 16 after the acquisition. (4 marks)

(Total 12 marks)