The Management University of Africa

Sponsored by the Kenya Institute of Management

POSTGRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

MASTER OF BUSINESS ADMINSTRATION

BFO 501: CORPORATE FINANCE

DATE: 28th march, 2022

DURATION: 3 HOURS

MAXIMUM MARKS: 60

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. **DO NOT** write on this question paper.
3. This paper contains **FOUR (4)** questions.
4. Question **ONE** is compulsory.
5. Answer any other **TW0** questions.
6. Question **ONE** carries **30 MARKS** and the rest carry **15 MARKS** each.
7. **Write all your answers in the Examination answer booklet provided.**

QUESTION ONE

Read the Case Study below carefully and answer the questions that follow:

Dove Construction Company Ltd made a Sh.100 million bondage 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 here below are the details about the two bond issues:

Old Bonds: The outstanding bonds 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 of a nominal value of Sh.1,000 and the firm incurred Sh.390,000 in floatation costs. They are callable at Sh.1,120.

New Bonds: 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 Sh.525,000.

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

Required:

a) Calculate the after-tax cash inflows expected from the unamortized portion of the old bond's issuance cost. **(2 Marks)**

b) Calculate the annual after-tax cash inflows from the issuance of the new bonds assuming the 10-year amortization. **(2 Marks)**

c) Calculate the after-tax cash outflow from the call premium required to retire the old bonds. **(2 Marks)**

d) Determine the incremental initial cash outlay required to issue the new bonds. **(10 Marks)**

e) Calculate the annual cash-flow savings, if any, expected from the bond refunding. **(8 Marks)**

f) Examine any three of political risks that face multi-national firms in foreign countries. **(6 Marks)**

QUESTION TWO

a) Examine any TWO services provided by financial intermediaries in your country **(4 Marks)**

b) Several methods exist for evaluating investment projects under capital budgeting. Discuss any five features of an ideal investment appraisal method. **(5 Marks)**

c) Describe the three forms of capital market efficiency. **(6 Marks)**

QUESTION THREE

a) Explain fully the effect of the use of debt capital on the weighted average cost of capital of a company. **(3 Marks)**

b) Rafiki Hardware Tools Company Limited sells plumbing fixtures on terms of 2/10 net 30. Its financial statements for the last two years are as follows:

Year	**2016 Sh.'000'**	**2017 Sh.'000'**
Cash	20,000	5,000
Accounts receivable	260,000	290,000
Inventory	480,000	600,000
Net fixed assets	800,000	800,000
	1,560,000	1,695,000
Accounts payable	300,000	380,000
Accruals	210,000	225,000
Bank loan, short term	100,000	140,000
Long term debt	300,000	300,000
Common stock	100,000	100,000
Retained earnings	550,000	550,000
	1,560,000	1,695,000
Additional information:		
Sales	4,300,000	3,800,000
Cost of goods sold	3,600,000	3,300,000
Net profit	200,000	100,000

Required:

For each of the two years, calculate the following ratios:

i) Acid test ratio **(2 Marks)**
ii) Average collection period **(2 Marks)**
iii) Inventory turnover **(2 Marks)**
iv) Total debt/equity **(2 Marks)**
v) Net profit margin **(2 Marks)**
vi) Return on assets. **(2 Marks)**

QUESTION FOUR

A piece of equipment requiring the investment of 2.2 million is being considered by Charo Foods Ltd. The equipment has a ten-year useful life and an expected salvage value of Sh 200,000. The company uses the straight-line method of depreciation for analyzing investment decisions and faces a tax rate of 40%. For simplicity assume that the depreciation method is acceptable for tax purposes and a pessimistic forecast projects cash earnings before depreciation and taxes at Sh 400,000 per year compared with an optimistic estimate of Sh 500,000 per year. The probability associated with the pessimistic estimate is 0.4 and 0.6 for the optimistic forecast. The company has a policy of using a hurdle rate of 10% for replacement investments, 12% (its cost of capital) for revenue expansion investments into existing product lines and 15% projects involving new areas or new product lines.

REQUIRED:

(a) Compute the expected annual cash flows associated with the proposed equipment investments. **(5 Marks)**

(b) Would you recommend acceptance of this project if it involved expansion of sales for an existing product? **(5 Marks)**

(c) Would it be acceptable if it was for the replacement of equipment with a book value of Sh 200,000 at the end of the tenth year but which could be sold at that time for only Sh 40,000? **(5 Marks)**