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**GARISSA UNIVERSITY**

**UNIVERSITY EXAMINATION 2020/2021 ACADEMIC YEAR THREE**

**SECOND SEMESTER EXAMINATION**

**SCHOOL OF BUSINESS AND ECONOMICS**

**FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT**

**COURSE CODE: BBM 312**

**COURSE TITLE: CORPORATE FINANCE**

**EXAMINATION DURATION: 2 HOURS**

**DATE: 20/08/2021 TIME: 09.00-11.00 AM**

**INSTRUCTION TO CANDIDATES**

* **The examination has FIVE (5) questions**
* **Question ONE (1) is COMPULSORY**
* **Choose any other TWO (2) questions from the remaining FOUR (4) questions**
* **Use sketch diagrams to illustrate your answer whenever necessary**
* **Do not carry mobile phones or any other written materials in examination room**
* **Do not write on this paper**

**This paper consists of FIVE (5) printed pages *please turn over***

**QUESTION ONE (COMPULSORY)**

1. Explain the following terms as used in capital structure of a firm.
2. Operating leverage **[2 marks]**
3. Financial leverage **[2 marks]**
4. Suppose the Co. intends to issue new share capital which will attract a floatation cost of 10% of the issued price. What will be the firm cost of new share capital assuming that the shares are currently selling at sh. 100 at the Nairobi Stock Exchange (NSE) and for the year just ended the company paid a dividend of sh. 8 which is expected to grow at 10% p.a. **[5 marks]**
5. Consider two firms L & U with the following characteristics

|  |  |  |
| --- | --- | --- |
| Details | Firm L | Firm U |
| EBIT | 900,000 | 900,000 |
| 7.5% of debt | 2M | - |
| Overall cost/WACC | 10% | 10% |

**Required**

1. Determine the value of each firm using net income approach **[4 marks]**
2. Confirm the overall cost of the two (2) firms. **[3 marks]**

(d) Explain four key motives for holding cash in the financial institutions **[4 marks]**

(e) H limited is evaluating an investment project which requires the importation of a new machine at a cost of 2,700,000. The machine has useful life of six years.

Additional information

1. The following additional costs would be incurred in relation to the machine.

**Sh.**

Freight 225,000

Installation & preproduction testing 375,000

Import duty 900,000

1. The machine is expected to increase the company’s annual cash flows (before tax) as shown below

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Year | 1 | 2 | 3 | 4 | 5 | 6 |
| Increase in cash flows | 1,760,000 | 1,360,000 | 1,050,000 | 900,000 | 840.000 | 75,000 |

1. The machine is to be fully depreciated over its useful life using the straight line method.
2. The corporate tax rate is 30% while the cost of capital is 12%.
3. The maximum acceptable payback period to the company for all capital projects is 4 years.

**Required**

1. Payback period of the machine **[4 marks]**
2. Net present value of the machine **[4 marks]**
3. Advise the company on whether to import the machine based on your result in (a) and (b) above respectively. **[2 marks]**

**QUESTION TWO [20 marks]**

1. Elucidate six (6) key reasons for valuing asset in a business **[6 marks]**
2. S Ltd’s share has a nominal value of ksh. 90. The company pays 12% of the nominal value of the share as dividend for the year. The current market price of the share is sh. 170 with 17% earning yield.

**Required:**

1. Earnings per share **[2 marks]**
2. Dividend cover **[2 marks]**
3. Price – earnings ratio **[2 marks]**
4. Company in need of additional funding may issue shares to obtain the funds. Describe any four ways through which shares may be issued **[8 marks]**

**QUESTION THREE [20 marks]**

1. Explain four factors that could influence the cost of capital  **[4 marks]**
2. Java limited projects that cash outlay of Ksh 45M will occur uniformly throughout the year. The company plans to meet its cash requirement by selling marketable securities from its portfolio. The expected return from the company’s marketable securities is 8% p.a. and the cost per transaction of converting marketable security into cash is Ksh. 30.

**Required**

Using the Barmol’s cash management model, determine:

1. The optimal cash balance **[2 marks]**
2. Average cash balance **[2 marks]**
3. Number of transaction between cash & marketable securities per year.

**[2 marks]**

1. Discuss the three main classifications of investment decision **[6 marks]**
2. Explain four (4) fundamental importance of the investment decision **[4 marks]**

**QUESTION FOUR [20 marks]**

1. Discuss the following dividend theories
2. Residual dividend theory **[2 marks]**
3. MM dividend irrelevance theory **[2 marks]**
4. The bird-in-the-hand theory **[2 marks]**
5. The tax preference theory **[2 marks]**
6. Explain three assumptions of Modigliani and Miller irrelevance theory **[3 marks]**
7. Garissa University is considering investing in one of the mutually exclusive projects. The relevant cash flows of each of the projects are shown in the table below

|  |  |  |
| --- | --- | --- |
|  | Project X | Project Y |
|  | Sh’000’ | Shs ‘000’ |
| Initial investment  Cash flows  Year: 1  2  3  4  5  6 | 38,500  25,000  -11,000  20,000  15,000  6,000  5,000 | 37,000  30,000  8,000  -4,000  22,000  -10,000  15,000 |

The firms cost of capital is 15% and the cash flows accrue at the end of the year.

Required:

Calculate for each project

1. Discounted payback period **(6 marks)**
2. Profitability index **(3 marks)**

**QUESTION FIVE [20 marks]**

1. Distinguish between the following sets of terms:

i. Cash dividend and stock dividends. **[2 marks]**

ii. Direct cost and Indirect cost **[2 marks]**

1. Consider a four-year project with an initial outlay of 450,000 and a salvage value of sh. 40,000. The project is expected the following profit after tax.

Year profit after tax

1. 150,000
2. 90,000
3. 70,000
4. 90,000

**Required**

1. Determine the accounting rate of return of the project **[5 marks]**
2. Given that the management has set a return on investment at 39% state whether the project would be accepted or rejected. **[2 marks]**
3. Company y has issued and financed its investment through equity capital. The treasury bills are currently placed at 9%. The average market return is 20%. The beta of the company share is 1.2.

**Require:**

Calculate the cost of equity capital using CAPM method. **[4 marks]**

1. Discuss six steps involved in the financial planning process **[5 marks]**