UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

SUPPLEMENTARY EXAMINATION PAPER 2007

DEGREE/DIPLOMA AND YEAR OF STUDY: B. COMM V

TITLE OF PAPER : BUSINESS FINANCE II

TIME ALLOWED : THREE (3) HOURS

INSTRUCTIONS

1. TOTAL NUMBER OF QUESTIONS ON THIS PAPER: FOUR (4).
2. ANSWER ALL QUESTIONS
3. THE MARKS AWARDED FOR A QUESTION/PART ARE INDICATED AT THE END OF EACH QUESTION/PART OF QUESTION.
4. ALL CALCULATIONS ARE TO BE MADE TO THE NEAREST LILANGENI
5. WHERE APPLICABLE, SUBMIT ALL WORKING CALCULATIONS

NOTE: YOU ARE REMINDED THAT IN ASSESSING YOUR WORK, ACCOUNT WILL BE TAKEN OF ACCURACY OF THE LANGUAGE AND THE GENERAL QUALITY OF EXPRESSION, TOGETHER WITH THE LAYOUT AND PRESENTATION OF YOUR FINAL ANSWER.

SPECIAL REQUIREMENTS: P.V. TABLES

THIS PAPER IS NOT TO BE OPENED UNTIL PERMISSION HAS BEEN GRANTED BY THE INVIGILATOR.

QUESTION 1

Tracy (Pty) Ltd is a private company with intentions of obtaining a stock market listing in the near future. The company is wholly equity-financed at present but the directors are considering a new capital structure prior to its becoming a listed company.

Tracy operates in an industry where the average asset beta is 1.2. The company's business risk is estimated to be similar to that of the industry as a whole. The current level of earnings before interest and taxes is E800.000. This earnings level is expected to be maintained for the foreseeable future.

The rate of return on riskless assets is at present 10% and the return on the market portfolio is 15%. These rates are post-tax and are expected to remain constant for the foreseeable future. Tracy is considering introducing debt into its capital structure by one of the following methods:

1. E1000.000 — 10% debentures at par, secured on land and buildings of the company;
2. E2000.000 — 12% unsecured loan stock at par.

The rate of company tax is expected to remain at 33%, and interest on debt is tax deductable.

(a) You are required to calculate, for each the two options:

- (i) values of equity and total market values
- (ii) debt/equity ratios
- (iii) cost of equity (9 Marks)

(b) You are required to list the main problems and costs which might arise for a company experiencing a period of severe financial difficulties. (6 Marks)

(c) Explain any weaknesses of both the Traditional & Modigliani & Miller Theories and discuss how useful they might be in the determination of the appropriate capital structure for a company. (10 Marks)

Total (25 Marks)

QUESTION 2

(a) Phiri Ltd has recently obtained a listing on The Stock Exchange. 90% of the company's shares were previously owned by members of one family but, since the listing, approximately 60% of the issued shares have been owned by other investors.

Phiri's earnings and dividends for the five years prior to the listing are detailed below:

Years prior to listing	Profit after tax E	Dividend per share Cents
5	1,800,000	3.6
4	2,400,000	4.8
3	3,850,000	6.16
2	4,100,000	6.56
1	4,450,000	7.12
Current year	5,500.000 (estimate)	

The number of issued ordinary shares was increased by 25% three years prior to the listing and by 50% at the time of the listing. The company's authorised capital is currently E25,000,000 in 25 cents ordinary shares, of which 40,000,000 shares have been issued. The market value of the company's equity is E78,000,000.

The board of directors is discussing future dividend policy. An interim dividend of 3.16 cents per share was paid immediately prior to the listing and the finance director has suggested a final dividend of 2.34 cents per share.

The company's declared objective is to maximise shareholder wealth.

REQUIRED:

(1) Comment upon the nature of the company's dividend policy prior to the listing and discuss whether such a policy is likely to be suitable for a company listed on The Stock Exchange. (6 Marks)

(2) Discuss whether the proposed final dividend of 2.34 cents is likely to be an appropriate dividend:
   (i) if the majority of shares are owned by wealthy private individuals;
   (ii) if the majority of shares are owned by institutional investors.

(10 Marks)

(3) The company's profit after tax is generally expected to increase by 15% per year for three years and 8% per year after that. Phiri's cost of equity capital is estimated to be 12% per year. Dividends may be assumed to grow at the same rate as profits.

Required:

(i) using the dividend valuation model, give calculations to indicate whether Phiri's shares are currently undervalued or overvalued. (6 Marks)

(ii) Briefly outline the weaknesses of the dividend valuation model. (3 Marks)

Total (25 Marks)

QUESTION 3

The directors of Nhleko Ltd, a medium sized private company, have been approached by a large public company which is interested in purchasing their business. The directors of Nhleko have indicated that they would like to receive cash for their shares, which is acceptable to the prospective purchaser. They have been asked by the public company to state the price at which they would be willing to sell. You have been asked to advise Nhleko Ltd.

Extracts from the last set of published accounts for Nhleko for 2007 are given below:

	E
Profit before tax and interest	5,000,000
Interest	900,000
Profits before tax	4,100,000
Taxation	1,666,000
Profits after tax	2,434,000
Extraordinary item	400,000
	2,034,000
Dividends paid: preference shares	100,000
Ordinary shares	900,000
Profits retained	**1,034,000**

The balance sheet as at 30 June, 2007 is as follows:

	E
Ordinary shares (E1.00 par)	19,000
5% preference shares (E1.00 par)	3,000
Reserves	9,000
Debentures	9,000
Creditors	5,000
	45,000
Goodwill	4,000
Freehold property	10,000
Plant and machinery	20,000
Investments	4,000
Stock	2,000
Debtors	4,000
Cash	1,000
	45,000

For the year ending 30 June 2005, profits before interest and tax were E9 million, and in the year 30 December 2006 they were E7 million. The owners of the preference shares have found a financial institution who will buy at a price of E0.30 per preference share. They are willing to sell at this price.

You are asked to take the following factors into account in calculating a value per share:

1. The prospective buyer has agreed to buy the debentures at a price of E75 per E100 of stock,

2. It has been ascertained that the current rental value of the freehold property is E1.3 million and that this could be sold to a financial institution on the basis of offering a 7% return to the freeholder,

3. Nhleko investments has a current market value of E6.5 million,

4. There is an amount of E750,000 shown in the 2007 debtors figure which is thought to be irrecoverable.

Two companies in the same business as Nhleko are quoted on the stock market; however, both are slightly bigger in size than Nhleko. The most recent financial data relating to the companies is given below:

	Par value of shares	Market Price per share	P/E ratio	Net dividend per share	Times covered	Yield gross%
Gama	E1.00	E3.50	11.3	E0.12	2.6	4.9
Da-Silva	E0.50	E1.25	8.2	E0.04	3.8	4.1

The directors of Nhleko are naturally interested in obtaining the highest price possible for their shares. Based on the following valuation methods:

(i) the net asset value
(ii) the price earnings ratio
(iii) the dividend yield

You are required to:

(a) Determine the highest possible asking price for the shares that can be justified on the basis of the available information. You are required to explain to the directors how you have arrived at the alternative prices. (16 Marks)

(b) Advise the directors on the lowest price at which they should be willing to sell. (9 Marks)

Total (25 Marks)

QUESTION 4

Outline the problems and opportunities which floating, rather than fixed, currency exchange rates present to the financial management and finance raising functions of firms with overseas subsidiaries, customers or suppliers.

(25 Marks)

Present Value Table

Present value of 1 i.e. $(1 + r)^{-n}$
where r = discount rate
n = number of periods until payment

Discount rates (r)

Periods (*n*)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	
1	0·990	0·980	0·971	0·962	0·952	0·943	0·935	0·926	0·917	0·909	1
2	0·980	0·961	0·943	0·925	0·907	0·890	0·873	0·857	0·842	0·826	2
3	0·971	0·942	0·915	0·889	0·864	0·840	0·816	0·794	0·772	0·751	3
4	0·961	0·924	0·888	0·855	0·823	0·792	0·763	0·735	0·708	0·683	4
5	0·951	0·906	0·863	0·822	0·784	0·747	0·713	0·681	0·650	0·621	5
6	0·942	0·888	0·837	0·790	0·746	0·705	0·666	0·630	0·596	0·564	6
7	0·933	0·871	0·813	0·760	0·711	0·665	0·623	0·583	0·547	0·513	7
8	0·923	0·853	0·789	0·731	0·677	0·627	0·582	0·540	0·502	0·467	8
9	0·914	0·837	0·766	0·703	0·645	0·592	0·544	0·500	0·460	0·424	9
10	0·905	0·820	0·744	0·676	0·614	0·558	0·508	0·463	0·422	0·386	10
11	0·896	0·804	0·722	0·650	0·585	0·527	0·475	0·429	0·388	0·350	11
12	0·887	0·788	0·701	0·625	0·557	0·497	0·444	0·397	0·356	0·319	12
13	0·879	0·773	0·681	0·601	0·530	0·469	0·415	0·368	0·326	0·290	13
14	0·870	0·758	0·661	0·577	0·505	0·442	0·388	0·340	0·299	0·263	14
15	0·861	0·743	0·642	0·555	0·481	0·417	0·362	0·315	0·275	0·239	15

	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%	
1	0·901	0·893	0·885	0·877	0·870	0·862	0·855	0·847	0·840	0·833	1
2	0·812	0·797	0·783	0·769	0·756	0·743	0·731	0·718	0·706	0·694	2
3	0·731	0·712	0·693	0·675	0·658	0·641	0·624	0·609	0·593	0·579	3
4	0·659	0·636	0·613	0·592	0·572	0·552	0·534	0·516	0·499	0·482	4
5	0·593	0·567	0·543	0·519	0·497	0·476	0·456	0·437	0·419	0·402	5
6	0·535	0·507	0·480	0·456	0·432	0·410	0·390	0·370	0·352	0·335	6
7	0·482	0·452	0·425	0·400	0·376	0·354	0·333	0·314	0·296	0·279	7
8	0·434	0·404	0·376	0·351	0·327	0·305	0·285	0·266	0·249	0·233	8
9	0·391	0·361	0·333	0·308	0·284	0·263	0·243	0·225	0·209	0·194	9
10	0·352	0·322	0·295	0·270	0·247	0·227	0·208	0·191	0·176	0·162	10
11	0·317	0·287	0·261	0·237	0·215	0·195	0·178	0·162	0·148	0·135	11
12	0·286	0·257	0·231	0·208	0·187	0·168	0·152	0·137	0·124	0·112	12
13	0·258	0·229	0·204	0·182	0·163	0·145	0·130	0·116	0·104	0·093	13
14	0·232	0·205	0·181	0·160	0·141	0·125	0·111	0·099	0·088	0·078	14
15	0·209	0·183	0·160	0·140	0·123	0·108	0·095	0·084	0·074	0·065	15