79

COURSE CODE: AC 503/IDE AC503 (M) 2008

UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

MAIN EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY	:	B COMM V
TITLE OF PAPER	:	CORPORATE FINANCE 11
COURSE CODE	:	AC 503
TIME ALLOWED	:	THREE (3) HOURS
INSTRUCTIONS	1.	TOTAL NUMBER OF QUESTIONS ON THIS PAPER: FOUR (4)
	2.	ANSWER ALL QUESTIONS
	3.	WHERE APPLICABLE ALL WORKINGS SHOULD BE SHOWN
	4.	ALL CALCULATIONS ARE TO BE MADE TO THE NEAREST LILANGENI.

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 REQUIREMENT: PV TABLES

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

QUESTION 1

The chairman of Slack decides that the company should increase the proportion of debt in its capital structure. Currently the company has 10% debt in its capital structure, and an equity beta of 0.8. The debt is considered risk free and yields an expected return of 5%, whereas the stock market expected return is 13%. The market capitalization of the company is currently $360 million. The chairman of Slack thinks that she can increase the proportion of debt to 60% by paying a one-time special dividend and issuing debt for the amount of this dividend. Then debt would have an expected return of 6%.

(a) What is the debt beta, the asset beta, and the cost of capital of the company before the refinancing? ***(9marks)***

(b) What is the risk premium on the stock market? ***(3marks)***

(c) What is the total value of the company before the recapitalization? What is the amount of debt issued and the dividend paid if the company recapitalises? ***(3marks)***

(d) What is the beta and the required rate of return of the common stock after the refinancing? ***(6marks)***

(e) Discuss briefly how internal and external factors can impact the organization's WACC. ***(4marks)***

QUESTION 2

You have collected the following information regarding ZZ Ltd.

Sales	23,400,000
Operating costs	15,000,000
EBIT	8,400,000
Interest	1,600,000
	6,800,000
Tax	2,720,000
Net Income	**4,080,000**

The corporate tax is 40%. The cost of equity of an equivalent ungeared firm in the same risk class is 24%. Debt capital has a yield of 16%.

(a) What is the value of the firm according to MM proposition 1? ***(3marks)***

(b) What should be the cost of equity of the geared firm (ke) according to MM proposition 2 ***(10marks)***

(c) What is the value of the firm according to MM with corporate taxes? ***(6marks)***

(d) What is the cost of equity of the firm according to MM Proposition 2 adjusted for corporate taxes? ***(6marks)***

QUESTION 3

(a) What are the five basic mechanisms for establishing exchange rates? ***(10marks)***

(b) Explain the costs and benefits that are associated with each exchange rate mechanism ***(15marks)***

QUESTION 4

S Ltd. a Swaziland company is considering making a five year investment in USA. The project will be for five years and it will result in the foreign currency operating cashflow as shown below:

1. Revenue in the first year will be USD 6 000 000. It will increase by 15% every year.
2. Operating costs will be USD 5 000 000 in the first year. They are estimated to increase by 10% every year.
3. The salvage value in year five will be USD 400 000

The current exchange rate between Swaziland and USA is L1.05/USD. The forecast exchange rates over the same period are as follows:

Year	1	2	3	4	5
Exchange rate SZL/USD	SZL0.95/USD	SZL0.90/USD	SZL0.85/USD	SZL0.8/USD	SZL0.80/USD

For the investment to take place, the following are required:

- Old building : USD 500 000
- Equipment : USD 900 000 with installation cost of USD 100 000
- Working capital: USD 300 000

Cashflow generated is in foreign currency terms and the following conditions hold:

1. Foreign country's tax rate is 35%.
2. Dividends and fees withholding tax is 40%.
3. In order to encourage investment USA offers a 40% investment allowance for new equipment and 20% for old buildings.
4. Dividends and royalties can be fully remitted.
5. A management fee of 2% of yearly sales not included in the operating expenses is charged by the firm.
6. The project is financed by 40% debt and 60% equity. The debt is acquired in USA at an interest rate of 20%. The principal is paid at maturity in 5 years and yearly interest rate is paid for 5 years.
7. The cost of capital for the firm is 24% and S Ltd's policy is to assess foreign projects at a higher rate of 26%.
8. Remittances into Swaziland will be subject to the following taxes: Dividends at 20% and Royalties at 35%.

Required:

1. Calculate the NPV of the project on the basis that it is locally owned in the USA. ***(10 marks)***
2. Determine the viability of the project in SZL terms. ***(5 Marks)***
3. Determine the viability of the project in remitted cashflow terms ***(10 marks)***

End of Question Paper

Present value interest factor of $1 per period at i% for n periods, PVIF(i,n).

Period	0.01	0.02	0.03	0.04	0.05	0.06	0.07	0.08	0.09	0.10	0.11	0.12	0.13	0.14	0.15	0.16	0.17	0.18	0.19	0.20	0.22	0.24	0.26	0.28
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833	0.820	0.807	0.794	0.781
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694	0.672	0.650	0.630	0.610
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579	0.551	0.525	0.500	0.477
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482	0.451	0.423	0.397	0.373
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402	0.370	0.341	0.315	0.291
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335	0.303	0.275	0.250	0.227
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279	0.249	0.222	0.198	0.178
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233	0.204	0.179	0.157	0.139
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194	0.167	0.144	0.125	0.108
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162	0.137	0.116	0.099	0.085
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135	0.112	0.094	0.079	0.066
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112	0.092	0.076	0.063	0.052
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093	0.075	0.061	0.050	0.040
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078	0.062	0.049	0.039	0.032
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065	0.051	0.040	0.031	0.025
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054	0.042	0.032	0.025	0.019
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.080	0.052	0.045	0.034	0.026	0.020	0.015
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038	0.028	0.021	0.016	0.012
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031	0.023	0.017	0.012	0.009
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026	0.019	0.014	0.010	0.007
25	0.780	0.610	0.478	0.375	0.295	0.233	0.184	0.146	0.116	0.092	0.074	0.059	0.047	0.038	0.030	0.024	0.020	0.016	0.013	0.010	0.007	0.005	0.003	0.002
30	0.742	0.552	0.412	0.308	0.231	0.174	0.131	0.099	0.075	0.057	0.044	0.033	0.026	0.020	0.015	0.012	0.009	0.007	0.005	0.004	0.003	0.002	0.001	0.001
35	0.706	0.500	0.355	0.253	0.181	0.130	0.094	0.068	0.049	0.036	0.026	0.019	0.014	0.010	0.008	0.006	0.004	0.003	0.002	0.002	0.001	0.001	0.000	0.000
40	0.672	0.453	0.307	0.208	0.142	0.097	0.067	0.046	0.032	0.022	0.015	0.011	0.008	0.005	0.004	0.003	0.002	0.001	0.001	0.001	0.000	0.000	0.000	0.000
50	0.608	0.372	0.228	0.141	0.087	0.054	0.034	0.021	0.013	0.009	0.005	0.003	0.002	0.001	0.001	0.001	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000