

UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

SUPPLEMENTARY EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY : **B COM IV**

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: **NONE**

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

QUESTION 1

The following information relates to company X Ltd:

Source	Book values E'000s	Face values (E)	Price (E)
Current Liabilities	75,000.00	-	-
Long term liabilities	180,000.00	100.00	150.00
Preference stock	135,000.00	1.00	0.70
Common stock	240,000.00	0.50	2.50
Total	630,000.00		

The long term debt and the current liabilities have a before tax cost of 24% and 26% respectively. X. Ltd's market value of current liabilities is E75 000.00. The preference stock dividend rate is 20%, the beta of the firms stock is 1.3, the average market return is 34% and the risk free rate is 16%. The applicable tax rate is 35%

Required:

- (a) Determine the cost of each source of financing *(5 marks)*
- (b) Calculate WACC using book values *(5 marks)*
- (c) Calculate WACC using market values. *(10 marks)*
- (d) Some determinants of the cost of capital are beyond the firm's control. Give two examples? *(5 marks)*

QUESTION 2

- (a) Preference shares have a fixed dividend of 16cents in perpetuity. The firm is planning to pass the next two dividends and pay the future dividends when due.
- (i) If the required rate of return on the preference shares is now 14%. What is the value of the preference share? **(8 marks)**
- (ii) What would be the value of the preference shares if the dividends are not passed? **(4 marks)**
- (b) A debenture has a par value of E100.00, 12 years to maturity and a coupon rate of 16%.
- (i) If the current yield is 18% what is the value of the debenture? **(4 marks)**
- (ii) If the current yield is 12% what is the value of the debenture? **(4 marks)**
- (c) What is the use of valuation when making security investment decisions and making corporate finance decisions **(5 marks)**

QUESTION 3

Lungile Limited is presently all equity financed. The company is assessing whether to issue E2 million in perpetual debt at 15% interest and repurchase some of its common stock of the same amount. The firm has a Net Operating Income of E1million and the cost of equity of 20%.

- (a) What is the value of the un-gearred firm according to MM without taxes? **(4 marks)**
- (b) What is the resultant cost of equity with gearing according to Modigliani and Miller with no taxes **(4 marks)**
- (c) What is the value of the un-gearred firm with a tax rate of 35%? **(4 marks)**
- (d) What is the value of the geared firm with a tax rate of 35% according to MM? **(4 marks)**
- (e) Suppose the tax rate was 45%
- (i) what would be the value of the tax shield and **(2 marks)**
- (ii) the firm? **(2 marks)**
- (f) If we consider the effect of taxes, what is the optimal capital structure? **(5 marks)**

QUESTION 4

Jerry Corporation, a Swaziland based firm is analysing an investment proposal from its subsidiary in a foreign market. The investment will be for 4 years and is expected to cost P80 000 000 in foreign currency. The current exchange rate is E2.25/P

Year	1	2	3	4
After tax cashflows ('000)	P25 000	P28 000	P30 000	P32 000
Royalties ('000)	P 2 000	P 2 000	P 2 000	P 2 000
Forecast Exchange rate (per P)	E2.3	E2.4	E2.45	E2.5

- a) The after tax cashflows are the same as the annual net profit.
- b) The after tax cashflows have been calculated as if the company is locally owned in the foreign country.
- c) The tax rate in the foreign country is 30%.
- d) The royalties have been included in the calculation of the after tax cash flow and treated as an expense.
- e) All remittable dividends and royalties will be remitted when realised.
- f) The cost of capital for the foreign project is 20%. The cost of capital for remittable cash flows is 26%.
- g) For foreign country tax and dividend purposes profit has to be calculated as if the project is a local one.
- h) The firm will realise P16 000 000 on termination of the project. This amount is freely remittable.
- i) Foreign dividends are taxed in Swaziland at 15%. Capital flows and royalties are not taxed in Swaziland.

Foreign government regulations on foreign investment:

- j) Dividends have a withholding tax of 10%.
- k) All royalties are freely remittable at the end of each period but a tax of 20% is charged. The above profit and cashflow calculations do not include this tax as royalties have been treated as an expense.
- l) There are no capital allowances available to foreign firms.

Required:

Calculate the Net Present Value of the project using:

- a) Foreign subsidiary cashflows. *(7 marks)*
- b) Remittable cash flows. *(16 marks)*
- c) Should the company invest in the project? *(2 marks)*

End of Question Paper