UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

MAIN EXAMINATION QUESTION PAPER

DEGREE	:	BACHELOR OF COMMERCE
TITLE OF PAPER	:	CORPORATE FINANCE 11
COURSE CODE	:	AC 503 / IDE AC503
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, LANGUAGE, THE GENERAL QUALITY OF EXPRESSION, TOGETHER WITH THE LAYOUT AND PRESENTATION OF YOUR FINAL ANSWER.

SPECIAL REQUIREMENT: CALCULATOR

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

QUESTION 1

(a) The Basket Weavers Company in Swaziland has 100,000 bonds outstanding that are selling at par value (E1000). Bonds with similar characteristics are yielding 7.5 percent. The company also has 1 million shares of 10.5 percent preferred stock outstanding with a par value of E100 and 5 million shares of common stock outstanding. The preferred stock sells for E56 per share. The common stock has a beta of 1.2 and sells for E38 a share. The Swaziland Treasury bill is yielding 3 percent and the return on the market is 12 percent. The corporate tax rate is 34 percent.

Required

Calculate the weighted average cost of capital? ***(10marks)***

(b) VW Woods Company a subsidiary of an international company operating in Swaziland has expected earnings before interest and taxes of E25 million. It has an unlevered cost of capital of 12%, and debt with both a book and face value of E75 million. The debt has an annual 9% percent coupon. The tax rate is 35 percent.

Required

(i) What is the value of the unleveraged firm? ***(4 marks)***

(ii) What is the value of the leveraged firm? ***(4 marks)***

(iii) What is the value of equity? ***(2 marks)***

(c) What is the effect of financial leverage on both Earnings Per Share (EPS) and Return On Equity (ROE). ***(5 marks)***

QUESTION 2

(a) What does Modigliani and Miller's 1958 theorem imply about a firm's optimal capital structure? Your answer should address:

(i) the Modigliani and Miller models of capital structure without corporate income taxes. ***(5 marks)***

(ii) the Modigliani and Miller models of capital structure with corporate income taxes, including how the introduction of corporate taxes affects the firm's choice of financing. ***(5 marks)***

(b) List and explain five Determinants of Dividend Policy ***(15marks)***

QUESTION 3

A Swaziland Multinational Corporation is considering a European opportunity. The size and timing of the after-tax cash flows are:

Year	€
0	-600
1	200
2	500
3	300

The inflation rate in the euro zone is p€ = 3%, the inflation rate in lilangeni is 6%, and the business risk of the investment would lead an unlevered Swaziland based firm to demand a return of i = 15%. The current exchange rate is (E/€) = E1.25/ €.

Required:

Determine whether this is a good investment from the perspective of the Swaziland shareholders? Explain your answer. ***(25 marks)***

QUESTION 4

In 2012, Digital Equipment, a leading manufacturer of mainframe computers, is the target of an acquisition bid by Compaq, which is a leading personal computer manufacturer in the world. The acquisition was partly motivated by the belief that Digital was a poorly managed firm and that Compaq would be a much better manager of Digital's assets. In addition, Compaq expected synergies, in the form of both cost savings (from economies of scale) and higher growth (from Compaq selling to Digital's customers). The suggested purchase price of Digital Equipment is E1,000,000. To analyze the acquisition, the following information about the statement of financial position and the forecast cash flow has been gathered.

Statement of financial position as at 31 December 2011

Equity and Liabilities	**E'000**
Equity	
Ordinary shares of E0.5par value	35
Reserves	43
Long Term Liabilities	
Long Term Loan	38
	116
Current Liabilities	31
Total Equity and Liabilities	**147**
Assets	
Non-Current Assets (Net)	**91**
Current Assets	
Stocks	29
Debtors	24
Cash	3
	56
Total Assets	**147**

CASH FLOW FORECAST	2012	2013	2014	2015	2016
Sales	E395,315	E461,244	E470,469	E479,878	E489,476
Pre-tax income	47,907	74,949	78,312	80,292	82,289
Income taxes	16,767	26,232	27,409	28,102	28,801
Net income	31,140	48,717	50,903	52,190	53,488
Plus: Depreciation	22,354	22,354	22,354	22,354	22,354
Less: Increase in working capital	9,388	888	906	924	942
Net cash flow	E44,106	E70,183	E72,351	E73,620	E74,900

Additional Information

The net cash flow in 2017 is expected to be E75,000.

The growth rate from 2017 to infinity (forever) is expected to be 10%.

The appropriate discount rate for Digital Equipment is 16%.

Required:

(a) Prepare the estimates of the value of Digital Equipment using the Discounted Cash flow (DCF) method *(15 marks)*

(b) Value of the assets of Digital Equipment using market values *(5 marks)*

(c) Calculate

- (i) the premium or discount (using the two methods; DCF and market values) for acquiring Digital Equipment and
- (ii) determine whether company Compaq should go ahead with the merger. *(5 marks)*

End of question paper