UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

SUPPLEMENTARY 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)

(i) ABC Ltd has a beta of 1.2. The rate of return on risk free assets is currently 9% and the market risk premium is 7%. Calculate the cost of ordinary shares for ABC Ltd.

(2 marks)

(ii) DEF Ltd has ordinary shares in issue that are currently trading at E30.00 per share. The next dividend is expected to amount to E2.00 per share. If DEF Ltd adopts a dividend growth rate of 5% that is expected to remain constant indefinitely, calculate the cost of equity. ***(2 marks)***

(iii) GHI has 11% E2.00 non redeemable preference shares in issue. If the preference shares are currently trading at E1.80 calculate the cost of preference shares.

(2 marks)

(iv) XY Company is financed by E10m, E100 par value, 10% redeemable debentures currently quoted at E100 each. The debentures would be redeemed in 10 years time at par. Corporate tax is 30%. Calculate the cost of the debentures. ***(2 marks)***

(b)You are provided with the following extract from the statement of financial position of capital Ltd. at 31 December 2010:

	E'million
Ordinary Share Capital (E2.00 shares each)	1.5
12% non redeemable preference share capital (E1.00 share each)	2.5
Retained Earnings	4.5
10% redeemable debentures	3.5
Total	**12**

Additional information

- The ordinary shares are currently trading at E12.00 per share, the preference shares at E1.10 each and the debentures at E90.00 per E100.00 nominal value.
- An ordinary dividend of 50cents per share has recently been paid and dividends are forecast to grow at 10% per annum for the foreseeable future
- The debentures are redeemable in six years time at par value
- Company tax rate is currently 28%

(i) Calculate the Weighted Average Cost of Capital (WACC) using book values. ***(9marks)***

(ii) Calculate the Weighted Average Cost of Capital (WACC) using market values ***(8 marks)***

QUESTION 2

(a) DD expects an EBIT of E10,000 every year forever. DD can borrow at 7 percent. Suppose DD currently has no debt and its cost of equity is 17 percent. Corporate tax rate is 35 percent.

(i) What is the value of the firm? ***(2 marks)***

(ii) What will the value be if DD borrows E15,000 and uses the proceeds to repurchase stock? ***(3 marks)***

(b) **Break-Even EBIT**

Link Park Corporation is comparing two different capital structures, an all-equity plan (Plan I) and a levered plan (Plan II). Under Plan I, Link Park would have 100,000 shares of stock outstanding. Under Plan II, there would be 50,000 shares of stock outstanding and E15 million in debt outstanding. The interest rate on the debt is 10 percent and there are no taxes.

(i). If EBIT is E2,000,000, which plan will result in the higher EPS? ***(6 marks)***

(ii). If EBIT is E7,000,000, which plan will result in the higher EPS? ***(6 marks)***

(iii). What is the break-even EBIT? ***(2 marks)***

(c) In the real world, would it be wise for a company to retain a dividend which shareholders were expecting, in order to invest in a positive NPV project? ***(6 marks)***

QUESTION 3

(a) BB Woods Coffee has expected earnings before interest and taxes of E34,500, an unlevered cost of capital of 14 percent, and debt with both a book and face value of E20,000. The debt has an annual 7 percent coupon. The tax rate is 35 percent.

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

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

(b) Swaziland Imports is an unlevered firm with an after-tax net income of E79,000. The unlevered cost of capital is 12 percent and the tax rate is 35 percent. What is the value of this firm? ***(2 marks)***

(c) (i) Draw a graph. Plot the cost of capital on the vertical axis and debt to equity ratio on the horizontal axis. Use the graph to illustrate the firms WACC, cost of equity, and cost of debt under M&M without taxes. ***(5 marks)***

(ii) Explain (in about half a page) what the graph tell us about firm value and its cost of capital under this theory. ***(5 marks)***

(d) What do you think is the typical stock market reaction to the announcement that a firm will increase its dividend payment? Why? ***(5marks)***

QUESTION 4

(a) Consider this European investment opportunity:

Year	$
0	-600
1	200
2	500
3	300

Additional information:

1. The interest rate in Swaziland is 15%
2. The inflation rate in US is 3%
3. The inflation rate in Swaziland is = 6%
4. The spot exchange rate of the dollar to the lilangeni is $S_{\$}(0)$ = E0.55265

Required:

Determine whether this is a good investment from the perspective of the Swaziland shareholders? ***(16 marks)***

(b) What are the different defensive tactics for mergers and acquisitions by the target firm? ***(9marks)***

End of question paper