UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING AND FINANCE

SUPPLIMENTARY EXAMINATION PAPER 2018/2019 ACADEMIC YEAR

PROGRAMME OF STUDY	Bachelor of Commerce
YEAR OF STUDY	Year 4 (Full Time/Part Time)
TITLE OF THE PAPER	Corporate Finance II
COURSE CODE	ACF 417/AC 426/ AC514
TIME ALLOWED	Three (3) Hours

INSTRUCTIONS

1. There are Four (4) questions, ANSWER ALL.
2. Begin the solution to each question on a new page.
3. The marks awarded for a question are indicated at the end of each question.
4. Show your necessary workings.

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 layout and presentation of your answer.

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

SPECIAL REQUIREMENT: FINANCIAL CALCULATOR

QUESTION ONE

a) Great Sound Music, Inc. has 20,000 shares of common stock outstanding at a market price of E26 a share. This stock was originally issued at E19 per share. The firm also has a bond issue outstanding with a total face value of E300,000 which is selling for 97 percent of face value. The cost of equity is 10 percent while the after tax cost of debt is 5 percent. The firm has a beta of 1.2 and a tax rate of 35 percent.

Required
Calculate Great Sound's weighted Average Cost of Capital (WACC)? **(10 marks)**

b) Sesimla Breweries is planning to market unleaded beer. To finance the venture it proposes to make a rights issue at E10 of one new share for every two shares held. (The company currently has outstanding 100,000 shares priced at E40 a share). Assuming that the new money is invested to earn a fair return, calculate the following:

(i)	Number of new shares.	**(2.5 Marks)**
(ii)	Amount of new investment	**(3.5 Marks)**
(iii)	Total value of the company after the rights issue.	**(3.5 Marks)**
(iv)	Total number of shares after the rights issue.	**(3.5 Marks)**
(v)	Stock price after the rights issue.	**(3.5 Marks)**
(vi)	Price of the right to buy one new share.	**(3.5 Marks)**

(20 Marks)
(Total 30 Marks)

QUESTION TWO

The Board of Directors of Triple K Limited is comparing two different capital structures: an all-equity plan and a levered plan. Under the all-equity plan, Triple K would have 10 000 000 shares in issue. Under the levered plan, there would be 5 000 000 shares and 10% perpetual debt worth R200 million. The tax rate is 25%.

(a) Calculate what the profit before interest (PBIT) would have to be for Triple K to have the same earnings per share (EPS) under each capital structure (break-even PBIT), and calculate this EPS. **(10 marks)**

(b) State <u>five</u> assumptions of Modigliani-Miller theories of capital structure. **(10 marks)**

QUESTION THREE

(a) Sushi Setting is a restaurant which uses a large amount of rice. The owner of Sushi Setting has a good relationship with a local farmer whose main crop is rice. If you and this farmer agree to set up a contract to purchase/sell rice,

i. State the contract you would use. (2 marks)
ii. Explain which party would assume the long position (2 marks)

iii. Explain which party would assume the short position (2 marks)

iv. How this contract would help to address any price concerns the farmer and sushi Setting may have. (4 marks)

(10 marks)

(b) List <u>five</u> differences between forward and futures contracts. **(10 marks)**

Total 20 Marks

QUESTION FOUR

I. The return shareholders require on their investment in a firm is called the:
   - A. dividend yield.
   - B. <u>cost of equity</u>.
   - C. capital gains yield.
   - D. cost of capital.
   - E. income return.

II. Which one of the following most accurately describes capital gearing?
   - A. The ratio of capital employed to sales.
   - B. The ratio of current borrowing to this year's capital repayments.
   - C. The ratio of debt to shareholders' funds or total assets.
   - D. The ratio of interest charges to profits.

III. To the issuing company, which one of the following is not an advantage of a convertible bond?
   - A. It offers a lower coupon than on a similar debenture.
   - B. The interest is tax deductible.
   - C. It can be self-liquidating.
   - D. It does not contribute to the overall borrowing levels.

IV. Which one of the following most accurately describes the function of credit rating agencies, such as Moody's or Standard & Poors?
   - A. A rating of the trustworthiness of a company's directors.
   - B. An assessment of the likelihood of consumers defaulting on credit card debt.
   - C. An assessment of the likelihood of a bond or loan interest and/or capital not being paid and the extent to which the lender is protected in the event of a default.
   - D. A rating service ranking banks in terms of the quantity of loans made in a particular period.

V. Which one of the following <u>most</u> accurately describes a debenture issued by a UK firm?
   - A. A financial asset with a right to receive interest and a share of a firm's profits.
   - B. A bond which entitles the owner to receive a share of the firm's assets in liquidation.
   - C. A long-term contract in which the debenture holder lends money to a company in return for promises of interest payments and capital repayment at maturity. The debenture is secured by either a fixed or a floating charge against the firm's assets.
   - D. A contract in which a lender provides finance to a firm in return for promises of interest payment and capital repayment at maturity. The debenture is unsecured.

VI. A junk bond is:

A. A promise made by the crew of a traditional Chinese ship.
B. A financial security issued by retail chains selling inexpensive items.
C. A financial instrument with predominantly debt characteristics but offering high rate and high risk.
D. A worthless bond.

VII. Which one of the following statements is false?
A. A cumulative preference share is one where the dividends due are only paid at the end of the share's life.
B. A participating preference share is one where the dividend may be increased if the company has high profits.
C. A redeemable preference share has a finite life.
D. A convertible preference share is one which can be converted into ordinary shares at specific dates and on pre-set terms.

VIII. Which one of the following is not an advantage for the firm that raises capital by selling preference shares?
A. Preference dividends need not be paid for one or more years.
B. Preference shares are an additional source of finance, but do not (usually) influence the ordinary shareholders.
C. The limits placed on the returns to preference shareholders mean that ordinary shareholders receive all the extraordinary profits when the firm is doing well.
D. The preference dividend is tax deductible.

IX. Which one of the following statements is false?
A. Usually providers of debt finance have no control over the direction of the company.
B. Usually debt holders oblige the firm to make interest and capital repayments on set dates – a failure to do so can lead to bankruptcy.
C. Debt holders often impose negative covenants on firms.
D. A floating charge debt holder can insist on the sale of a specific asset to satisfy a claim in the event of a default.

X. Which one of the following is false?
A. Ordinary shares represent the equity share capital of the firm.
B. Ordinary shareholders vote at meetings to determine important matters such as the composition of the board of directors.
C. Ordinary shareholders are promised a minimum annual return as a dividend.
D. Ordinary shareholders share in the rising prosperity of the firm.

XI. The risk-free rate of return is 6%. The risk premium on the average share is 7%. The beta of share A is 1.5. The beta of share B is 0.7. Which of the following is true, given that A offers a return of 18% and B offers a return of 12%?
A. Both A and B are underpriced relative to the security market line.
B. Both A and B are overpriced relative to the security market line.
C. A is underpriced and B is overpriced relative to the security market line.
D. A is overpriced and B is underpriced relative to the security market line.

XII. Which of these statements describes the systematic risk referred to in the CAPM?
A. The risk that the entire financial system might be adversely affected by a collapse of some key financial institutions.
B. That risk to a firm's shares which is due to specific events affecting that one firm.

C. The risk that is left after a firm has made use of hedging techniques in the derivative markets.
D. That risk which is common to all firms to some extent – it cannot be eliminated by diversification.

XIII. The cost of capital:
A. will decrease as the risk level of a firm increases.
B. is primarily dependent upon the source of the funds used for a project.
C. implies a project will produce a positive net present value only when the rate of return on the project is less than the predetermined cost of capital.
D. remains constant for all projects undertaken by the same firm.
E. depends on how the funds are going to be utilized.

XIV. The capital structure weights used in computing the weighted average cost of capital:
A. are based on the book values of total debt and total equity.
B. are based on the market value of the firm's debt and equity securities.
C. are computed using the book value of the long-term debt and the book value of equity.
D. remain constant over time unless the firm issues new securities.
E. are restricted to the firm's debt and common stock.

XV. Which one of the following statements is correct concerning the weighted average cost of capital (WACC)?
A. The WACC may decrease as a firm's debt-equity ratio increases.
B. When computing the WACC, the weight assigned to the preferred stock is based on the coupon rate multiplied by the par value of the stock.
C. A firm's WACC will decrease as the corporate tax rate decreases.
D. The weight of the common stock used in the computation of the WACC is based on the number of shares outstanding multiplied by the book value per share.
E. The WACC will remain constant unless a firm retires some of its debt.

Total Marks 30 Marks

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