

UNIVERSITY OF ESWATINI
DEPARTMENT OF ECONOMICS
MAIN EXAMINATION MAY 2019

PAPER TITLE : CORPORATE FINANCE II

COURSE CODE : ECO 428

INSTRUCTIONS:

1. ANSWER THREE QUESTIONS.
2. QUESTION ONE IS COMPULSORY.
3. TIME ALLOWED: TWO (2) HOURS

REQUIREMENTS

1. SCIENTIFIC CALCULATORS

This paper is not to be opened until permission has been granted by the invigilator.

QUESTION 1 (COMPULSORY AND CARRIES 40 MARKS)

Part A

Write short notes on the following:

- i. Risk premiums
- ii. Capital structure
- iii. Financial Distress
- iv. Capital budgeting
- v. Differentiate between systematic and unsystematic risk

[4 Marks each]

Part B

Suppose Supertech and Hyperdrive Companies have experienced the following returns in the last four years:

Year	Supertech Return	Hyperdrive Return
2001	-0.20	0.05
2002	0.50	0.09
2003	0.30	-0.12
2004	0.10	0.20

a) Calculate the following:

- i. Average returns [2]
- ii. The variances [10]
- iii. The standard deviations for each company's return. [2]

b) Which investment was more volatile? [2]

c) Rebecca invested E9, 000 in a stock that has an expected return equal to 18% and E12, 000 in a stock with an 8% expected return. What is the portfolio's expected return? [4]

QUESTION 2

- a) The general theories of capital structure have been developed along two main lines. Discuss these theories. [20]
- b) Construct an NPV profile for a capital budgeting project that costs E64, 000 and is expected to generate E18, 200 per year for five years. Using the NPV profile, determine the project's internal rate of return (IRR) and its net present value (NPV) at required rates of return equal to 10%, 13%, and 15%. [10]

QUESTION 3

- a) The CFO of SRA wants to calculate next year's EPS using different leverage ratios. SRA's total assets are E5 million, and its marginal tax rate is 40%. The company has estimated next year's EBIT for three possible economic states: E1.2 million with 0.2 probability, E800, 000 with a 0.5 probability, and E500, 000 with a 0.3 probability. Calculate SRA's expected EPS, standard deviation, and coefficient of variation for each of the following capital structures. Which capital structure do you recommend? [20]

Leverage (Debt/Assets)	Interest Rate	Shares of stock Outstanding
20%	6%	300,000
50	10	200,000

- b) Describe how conflicts that might arise when using the NPV and IRR techniques can be resolved using the modified internal rate of return (MIRR) technique. [10]

QUESTION 4

- a) Suppose the risk-free rate of return is 3.5% and the market risk premium is 7%. Stock U, which has a beta coefficient equal to 0.9, is currently selling for E28 per share. The company is expected to grow at a 4% rate forever, and the most recent dividend paid to stockholders was E1.75 per share. Is Stock U correctly priced? Explain. [8]
- b) Describe how business risk and financial risk affect a firm's capital structure. [8]
- c) Dunns Clothing is evaluating a new weaving machine that costs E90, 000. It is expected that the machine will generate after-tax cash flows equal to E54, 000 per year for two years. Dunns' required rate of return is 9%. Compute the project's:
- i. Internal rate of return (IRR) [5]
 - ii. Modified rate of return (MIRR) [5]
 - iii. Should the project be purchased? [4]