



JARAMOGI OGINGA ODINGA UNIVERSITY OF SCIENCE AND TECHNOLOGY
SCHOOL OF BUSINESS & ECONOMICS
UNIVERSITY EXAMINATION FOR THE DEGREE OF MASTERS OF BUSINESS
ADMINISTRATION WITH IT
2ND YEAR 1ST. SEMESTER 2019/2020 ACADEMIC YEAR
KISII CAMPUS-PART TIME

COURSE CODE: MBA 823

COURSE TITLE: CORPORATE FINANCE

EXAM VENUE:

STREAM: (MBA) YEAR 2 SEM 1.

DATE:

EXAM SESSION:

TIME: 3 HOURS

Instructions:

- 1. Answer ANY FOUR questions**
- 2. Candidates are advised not to write on the question paper.**
- 3. Candidates must hand in their answer booklets to the invigilator while in the examination room.**

QUESTION ONE (15 MARKS).

Financial statements analysis is a significant tool in predicting the bankruptcy and failure probability of business enterprises. After being aware about probable failure, both managers and investors can take preventive measures to avoid/minimize losses.

Required:

- a) Explain reasons for financial distress (4 marks)
- b) Describe the direct and indirect costs associated with financial distress (8 marks)
- c) What are the indicators of a financially distressed firm? (3 Marks)

QUESTION TWO (15 MARKS)

- a) Explain the following:
 - i. Trade off theory. (2 Marks)
 - ii. The pecking order theory. (2 Marks)
 - iii. Profit maximization (2 Marks)
 - iv. Shareholder's wealth maximization (2 Marks)

(b) Corporate financial managers make quite a number of decisions in the life time of an enterprise. Explain these decisions. (7 Marks)

QUESTION THREE (15 MARKS)

The following is the capital structure of XYZ Ltd as at 31/12/2018.

	Shs.'000"
Ordinary share capital Sh.125 par value	62,500
Reserves	121.500
14% debenture stock Sh.500 par value	<u>118500</u>
Capital employed	<u>302,500</u>

The management of the company consider the above capital structure to be optimal.

Additional information

1. Corporate tax rate is 30%
2. The company's EBIT average Ksh.75 Million per year. These earnings are expected to be maintained in the foreseeable future.
3. The ordinary shares are currently trading at ksh.400 per share
4. Currently the market price of debenture is ksh.525 per debenture.

Required

Using the net operating approach (incorporating taxes), calculate the company's

- i) Cost of equity. (5Mark)
- ii) After tax cost of debt (Market value weighted) (5 Marks)
- iii) Market weighted average cost of capital. (5 Marks)

QUESTION FOUR: (15 Marks)

- a) A LTD is targeting B ltd for a hostile takeover. The management of B Ltd. Is considering which defense mechanism to use in order to block the acquisition. Briefly explain to the management of B ltd the defense strategies applicable in a hostile takeover.(7Marks)
- b) Identify and explain dividend policy that can be adopted by financial manager in payment of dividends. (8 Marks)

QUESTION FIVE: (15 Marks)

Cedes limited has the following details of two of the future production plans. Only one of these machines will be purchased and the venture would be taken to be virtually exclusive. The

Standard model costs sh.50, 000 and the deluxe cost sh.88, 000 payable immediately. Both machines will require the input of the following:

- i) Installation costs of sh.20, 000 for Standard and sh.40,000 for the Deluxe
- ii) A sh.10, 000 working capital through their working lives.

Both machines have no expected scrap value at end of their expected working lives of 4 years for the Standard machine and six years for the Deluxe. The operating pre-tax net cash flows associated with the two machines are:

Year	1	2	3	4	5	6
Standard	28,500	25,860	24,210	23,410	-	-
Deluxe	36,030	30,110	28,380	25,940	38,500	35,100

The deluxe machine has only been introduced in the market and has not been fully tested in the operating conditions, because of the high risk involved the appropriate discount rate for the deluxe machine is believed to be 14% per annum, 2% higher than the rate of the standard machine. The company is proposing the purchase of either machine with a term loan at a fixed rate of interest of 11% per annum, taxation at 30% is payable on operating cash-flows one year in arrears and capital allowance are available at 25% per annum on a reducing balance basis.

Required

For both the Standard and the Deluxe machines, calculate the payback period. **(15 Marks)**

QUESTION SIX: (15 MARKS)

BBA ltd is considering acquiring IT ltd selected financial data for the two companies are as follows:

	BBA LTD	IT LTD
Annual sales(ksh.000)	1,500	180
Net income (ksh.000)	120	15
Ordinary shares outstanding (000)	30	6
Earnings per share (EPS) (Ksh.)	8	5
Market per share (ksh)	88	40

Both companies are in the 30% tax bracket.

Required:

- a) Calculate the maximum exchange ratio BBA Ltd. should agree to if it expects no dilution in earnings per share. **(2 Marks)**
- b) How many premiums would the shareholders of IT ltd. Receive at this exchange ratio? **(3 Marks)**
- c) Calculate post-merger EPS and MPS of the two companies if they settle on a price of sh.48.4 **(5 Marks)**
- d) Calculate BBA Ltd’s EPS if IT ltd’s shareholders accept one 20% convertible preference share (stated value sh.100) for every 5 ordinary shares they own. **(5 Marks)**