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OFFICE OF THE DEPUTY PRINCIPAL

ACADEMICS, RESEARCH AND STUDENTS' AFFAIRS

UNIVERSITY EXAMINATIONS

2019 /2020 ACADEMIC YEAR

3RD YEAR 1st SEMESTER REGULAR EXAMINATION

FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT

COURSE CODE: BBM 312

COURSE TITLE: CORPORATE FINANCE

DATE: Thursday 11TH March 2021 **TIME: 2.00-4.00 PM**

INSTRUCTION TO CANDIDATES

- **SEE INSIDE**

PLEASE TURN OVER

INSTRUCTIONS ANSWER QUESTION ONE AND ANY OTHER TWO QUESTIONS

QUESTION ONE (30 MARKS)

a) Explain three motives of making capital expenditure in an organization. (6 marks)
b) Highlight the four steps in Capital Budgeting Process (4 marks
c) A company operates a machine which has the following costs and resale value over its four year period. the purchase cost was sh 250,000

	Year 1	Year 2	Year 3	Year 4
Running costs	75,000	110,000	125,000	150,000
Resale value	150,000	100,000	75,000	25,000

The organization cost of capital is 10%. Analyze the above data to advice the management on how frequent the asset should be replaced. (10 marks)

d) XYZ is considering a project with the following cash flows

Year	Initial investment sh 000	Variable cost sh. 000	Cash inflows sh.000	Net cash flows sh. 000
0	14,000	…..	…..	……
1	….	(4,000)	13,000	9,000
2	……	(4,000)	13,000	9,000

Cash flows a rise from selling 850,000 units at sh 10 per unit and the cost of capital is 16%

Required

Measure the sensitivity of the project changes to

i. Initial investment (2 marks)
ii. Sales volume (2 marks)
iii. Selling price (2 marks)
iv. Variable cost (2 marks)
v. Cost of capital (2 marks)

QUESTION TWO (20 MARKS)

a) Jeremy limited wishes to expand its output by purchasing a new machine worth 170,000 and installation costs are estimated at 40,000/=. In the 4th year, this machine will call for an overhaul to cost 80,000/=. Its expected inflows are:

YEAR	1	2	3	4	5	6
INFLOWS sh.	60,000	72,650	35,720	48,510	91,630	83,715

This company can raise finance to purchase machine at 12% interest rate. Compute NPV and advise management accordingly. (10 marks)

b) A company is faced with the following 5 investment opportunities:

Investment	Cost	NPV	Profitability index
1	500,000	150,000	1.3
2	400,000	40,000	1.4
3	400,000	40,000	1.1
4	200,000	100,000	1.5
5	160,000	90,000	1.6

This company has ksh.750, 000available for investment projects, 3 and 4 are mutually exclusive. All of the projects are divisible. Which group should be selected in order to maximize the NPV. Indicate this NPV figure. (10 Marks)

QUESTION THREE (20 MARKS)

a) In the context of capital budgeting, explain the difference between "hard rationing" and "soft rationing". (6 marks)
b) Give three examples in each case for sources of soft and hard capital rationing respectively (6 marks)
c) Discuss the main factors which a company should consider when determining the appropriate mix of long-term and short-term debt in its capital structure. (8 marks)
d)

QUESTION FOUR (20 MARKS)

a) Explain the position of Modigliani and Miller (MM) with respect to the use of leverage in a firm. (6 marks)
b) Assume that two firms the levered firm (L) and the unlevered firm (U) are identical in all important respects except financial structure. Firm L has Sh 4 million of 7.5% debt, while Firm U uses only equity. Both firms have EBIT of Sh 900,000 and the firms are in the same business risk class. Initially assume that both firms have the same equity capitalization rate $K_{e(u)} = K_{e(L)} = 10\%$.

i. Determine the market value of equity. (7 Marks)
ii. Determine the total market value for each firm (7 Marks)

QUESTION FIVE(20 MARKS)

a) Explain the factors influencing cost of finance. (10 marks)
b) ABC ltd has had good trading period and wants to raise further finance from the following sources.
   - The company sold 100,000 ordinary shares of sh.100 with a flotation cost of sh. 20 each
   - It sold 5,000 preference shares of sh.100 at sh. 150 which carry a dividend of 16%
   - It sold 5,000 sh. 100 10% debentures at sh. 80
   - It sold10,000 sh. 50 12% debentures with issue cost of sh.15

   The company hopes to earn a return on the above finance of 18%

   Required

   Compute the cost ordinary share capital assuming that there is no retention. Take tax rate 30%. (10 marks)