(Knowledge for Development)

KIBABII UNIVERSITY

UNIVERSITY EXAMINATIONS

2022/2023 ACADEMIC YEAR

DEGREE THIRD YEARS SECOND SEMESTER

MAIN EXAMINATION

FOR THE DEGREE OF BACHELOR OF COMMERCE

COURSE CODE: BCF 312

COURSE TITLE: CORPORATE FINANCE

DATE: 18TH APRIL, 2023 **TIME:9.00AM – 11.00AM**

INSTRUCTIONS TO CANDIDATES

1. Answer a total of **three** questions; question **one** and any other **two** questions.
2. Question **one** carries **30** marks and each of the other two questions carry **20** marks each.

TIME: 2 Hours

SECTION A
QUESTION ONE

(a) Discuss the relevance of cost of capital to a business enterprise. (6 marks)

(b) *Highlight four limitations of long-term debt finance to an organization.* (4 marks)

(c) Despite the large investments in the stock exchange and various government incentives only a few companies are listed at the stock exchange of the *East African* Countries. Highlight four disadvantages to a company being listed. (4 marks)

(d)
   (i) Outline four drawbacks of Nairobi Stock Exchange Index. (4 marks)
   (ii) Explain four types of real options available in capital investment decisions. (4 marks)

(e) Citing relevant examples in each case, distinguish between "agency cost" and "financial distress costs." (5 marks)

Section B

QUESTION TWO

(a) "Every manager has to take three major decisions while performing the finance function." Briefly explain them. (8 marks)

(b) Ratori Limited has two mutually exclusive projects namely, Project A and Project B with initial cash outlay of Ksh. 50,000 each. The projects have a useful life of 5 years. The company's cost of capital is 12% with a corporate tax rate of 30%. The expected cash flows for the projects before depreciation and tax are given below:

Year	Project A **Ksh "000"**	Project B **Ksh "000"**
1	42	62
2	42	32
3	42	22
4	42	52
5	42	52

The company uses straight line metho of depreciation.

Required:

Using the profitability index (PI) approach, advise the management of Ratori Limited on the project to consider. (12 marks)

QUESTION THREE

(a) Naitiri LTD. has the following capital structure which is considered optimal:

	Sh. '000'
Debt (par @ Sh. 100)	250,000

Preferred stock (par @ Sh. 100)	150,000
Common stock (par @ Sh. 100)	600,000

The investor of Naitiri LTD expect earnings and dividend to grow at a constant rate of 9% in the future. The company has just paid a dividend of h. 3.6 per share and its stock currently sells at a price of sh. 60 per share. Treasury bonds yield 11% and the return on the market is 14%. Naitiri LTD is 1.51

New preferred stock can be sold at sh. 11 per share and floatation costs of sh. 5 per share.
The company's tax rate is 30% and it pays out all its earnings as dividend. 12% debentures with a maturity of 10 years can be sold at sh. 92 per debenture.

Required

The weighted average cost of capital (WACC) using market value weights (10 marks).

(b) An investor has two securities, A and B, with the following return characteristics:

State of economy	Probability	Returns Security A (%)	Returns Security B (%)
Recession	0.3	12	6
Stable	0.4	15	7.5
Expansion	0.3	10	5

Assess the riskiness of securities A and B. (10 marks)

QUESTION FOUR

(a) Alema Limited issued a new bond five years ago. The bond was sold at par value (sh. 1000) and has a maturity of 30 years. Coupon payments are made semi-annually. The interest rate has currently gone down to 10%.

Required:

i. The current price of the bond. (5 marks)
ii. The current yield to maturity of the bond. (3 marks)
iii. The capital gain on the bond. (2 marks)

(b) Discuss the benefits to a country of integrating its financial market with those of other countries. (10 marks)

QUESTION FIVE

(a) Summarize five reasons that might lead to a soft capital rationing in a limited company. (10 marks)

(b) (i) What is meant by the term "capital flight." (4 marks)
(ii) Discuss the causes of capital flight in developing economies. (6 marks)