



*(Knowledge for Development)*

**KIBABII UNIVERSITY**

**UNIVERSITY EXAMINATIONS**

**2022/2023 ACADEMIC YEAR**

**THIRD YEAR FIRST SEMESTER**

**SPECIAL/SUPPLEMENTARY EXAMINATION**

**FOR THE DEGREE OF BACHELOR OF BUSINESS MANAGEMENT**

**COURSE CODE: BBF311**

**COURSE TITLE: CORPORATE FINANCE**

**DATE: 15<sup>TH</sup> AUGUST, 2023**

**TIME: 11.00AM – 1.00PM**

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**INSTRUCTIONS TO CANDIDATES**

Answer Question One in Section A and Any other TWO (2) Questions in Section B

TIME: 2 Hours

**KIBU observes ZERO tolerance to examination cheating**

This Paper Consists of 3 Printed Pages. Please Turn Over.

## SECTION A

### QUESTION ONE

- a) Alpha company is contemplating conversion of 500 14% convertible bonds of Ksh.1,000 each. Market price of bond is Ksh. 1,080. Bond indenture provides that one bond will be exchanged for 10 share. Price earnings ratio before redemption is 20:1 and anticipated price earnings ratio after redemption is 25:1. Number of shares outstanding prior to redemption are 10,000. EBIT amounts to Ksh. 2,00,000. The company is in the 35% tax bracket. Should the company convert bonds into share? Give reasons. (10mks)
- b) You won ksh. 7M from betting. Being unemployed you wish to have a regular income over the next ten years. You have been approached by a life insurance company that sells annuity contracts and will pay you a fixed amount annually for ten years. Your opportunity cost of funds is 12%. How much annual income will you be receiving? (5mks)
- c) The ABC Company and the XYZ Company belong to the same risk class. They are identical in all aspects except that ABC Company has no debt in its capital structure, whereas XYZ Company employs debt in its capital structure. Relevant financial particulars of the two companies are given below

	ABC COMPANY	XYZ COMPANY
Net operating income	Shs. 500 000	Shs. 500 000
Debt interest	-	Shs. 200 000
Equity earnings	Shs. 500 000	Shs. 300 000
Equity capitalization rate	12%	14%
Market value of equity	Shs. 4,166,667	Shs. 2, 500,000
Market value of debt (Debt capitalization rate 8%)	-	Shs. 2,500,000
Total market value of the firm	Shs. 4,166,667	Shs. 4,642,857

Average cost of capital	12%	10.77%
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- i) You own shs. 10,000 worth of XYZ equity. Show what arbitrage you would resort to (10mks)
- ii) When will according to Modigliani and Miller this arbitrage cease (5mks)

## SECTION B

### QUESTION TWO

- a) XYZ plc. 18% debenture stock has 7 years to maturity. Interest is paid semiannually. If the nominal required rate of return is 20% p.a Calculate the value of Sh. 1000 face value debenture (3mks)
- b) With the use of a well-illustrated diagram, explain four major dividend policies that can be followed by a firm (7mks)
- c) Discuss 5 essential features of a sound capital mix (10mks)

### QUESTION THREE

- i) State and explain reasons why companies invest abroad (10mks)
- ii) Scrip dividends are paid through issue of ordinary shares of a company. State and explain important points that should be considered by the company before scrip issue is recommended (10mks)

### QUESTION FOUR

- i) Explain the implication of foreign exchange risk for financial management of multinational firms (10mks)
- ii) Discuss principles of corporate finance (10mks)

### QUESTION FIVE

KYC PLC. is considering two mutually exclusive projects requiring an initial cash outlay of Sh 10,000 each and with a useful life of 5 years. The company required rate of return is 10% and the appropriate corporate tax rate is 50%. The projects will be depreciated on a straight line basis. The before depreciation and taxes cashflows expected to be generated by the projects are as follows.

<b>YEAR</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
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Project A	Shs 4,000	4,000	4,000	4,000	4,000
Project B	Shs 6,000	3,000	2,000	5,000	5,000

**Required:** Calculate for each project

- i. The payback period (5mks)
  - ii. The average rate of return (5mks)
  - iii. The net present value (5mks)
  - iv. Internal Rate of Return (5mks)
- Which project should be accepted? Why?