

Uva Wellassa University

Faculty of Management

Degree of Bachelor of Business Management in Entrepreneurship and Management
THIRD YEAR SECOND SEMESTER EXAMINATION - AUGUST/SEPTEMBER 2011

EMG 461-2 Corporate Finance



Instructions to candidates:

No. of pages : Seven (07)

No. of questions : Five (05) Structured

: Four (04) Essay

Time allocation : One Hour & Forty Minutes

Marks allocated : 85 Marks

Question paper is not to be removed from examination hall

Index Number:



Part C – Essay Questions

Answer **only THREE (03)** questions from Part C **including question number 1.**

Marks allocation: 50 Marks

01. i. Comment on the following statement.

(4 Marks)

“The function of financial management is to review and control decisions to commit or recommit funds to new or ongoing uses. Thus, in addition to raising funds, financial management is directly concerned with production, marketing and other functions within an enterprise wherever decisions are made about the acquisition or destruction of assets.”

(Ezra Solomon)

ii. When can arise a conflict between shareholders' and managers' goals? How does wealth maximization goal take in to consideration of this conflict? (3 Marks)

iii. Why is consideration of time important in financial decision making? (3 Marks)

iv. Selected income statement and capital information for the Asha Manufacturing Company as follow (Rs 000):

		Capital	
Revenue	5,580	Debt	1,000
Cost/Expenses	<u>4,200</u>	Equity	<u>7,000</u>
EBIT	<u>1,380</u>	Total	<u>8,000</u>

Currently 700,000 shares of common stock are outstanding. The firm pays 15% interest on its debt and anticipates that it can borrow as much as it reasonably needs at that rate. The income tax rate is 40%.

Asha Company is interested in boosting the price of its stock. To do that management is considering restructuring capital to 50% debt in the hope that the increased EPS will have a positive effect on price. However, the economic outlook is shaky, and the company's CFO thinks there's a good chance that deterioration in business conditions will reduce EBIT next year. At the moment Asha's stock sells for its book value of Rs.10 per share.



- a. Estimate the effect of the proposed restructuring on EPS. (5 Marks)
- b. Assess the increase in risk that will come along with it by using the degree of financial leverage (5 Marks)

(Total Marks 20)

02. i. Giving the examples, Define systematic and unsystematic risks. (4 Marks)

ii. An investor holds two equity shares x and y in equal proportion with the following risk and return characteristics.

$$E(R_x) = 24\% \quad \sigma_x = 28\%$$

$$E(R_y) = 19\% \quad \sigma_y = 23\%$$

The returns of these securities have a positive correlation of 0.6.

- a. You are required to calculate the portfolio return and risk. (6 Marks)
- b. Further suppose that the investor wants to reduce the portfolio risk (σ_p) to 15%. How much should the correlation coefficient be to bring the portfolio risk to the desired level? (5 Marks)

(Total Marks 15)

03. i. What is interest rate risk? How would be the values of bonds affected when the market rate of interest changes? (4 Marks)

ii. Company debentures have a 10 percent coupon rate and a Rs.1000 face value. Interest is paid semi-annually and the debentures have 20 years to mature. If investors require a 12 percent yield, what is the bond's value? (5 Marks)

iii. The next dividend for the Sunset Company will be Rs.4 per share. Investors require a 16% return on companies such as Sunset. Sunset's dividend increases by 6% every year. Based on the dividend growth model,

- a. What is the value of Sunset's stock today? (3 Marks)
- b. What is the stock value in 4 years? (3 Marks)

(Total Marks 15)

04. i. Explain the relationship between firm value and cost of capital

(3 Marks)

ii. In calculating the Weighted Average Cost of Capital (WACC), if you had to use book values for either debt or equity, which would you choose? Why?

(3 Marks)

iii. Ross and Sons Company has a target capital structure that calls for 40 percent debt, 10 percent preferred stock, and 50 percent common equity. The firm's current after-tax cost of debt is 6 percent, and it can sell as much debt as it wishes at this rate. The firm's preferred stock currently sells for Rs.90 per share and pays a dividend of Rs.10 per share. However, the firm will realize only Rs.80 as the net amount per share from the sale of new preferred stock. Ross's common stock currently sells for Rs.40 per share. The firm recently paid a dividend of Rs.2 per share on its common stock, and investors expect the dividend to grow indefinitely at a constant rate of 10 percent per year.

b. What is the firm's cost of common stock?

(3 Marks)

c. What is the firm's cost of newly issued preferred stock?

(2 Marks)

d. What is the firm's Weighted Average Cost of Capital (WACC)?

(4 Marks)

(Total Marks 15)

