



# Uva Wellassa University

Faculty of Management

Bachelor of Business Management in Entrepreneurship and Management

3<sup>rd</sup> YEAR SEMESTER II - EXAMINATION - JUNE / JULY 2010

EMG 461-2 CORPORATE FINANCE



Uva Wellassa  
University

Index No:

**Instructions**

- No. of pages : Six (06)
- No. of questions : Part B - 05  
: Part C - 04
- Time : One hour and Forty Minutes
- Total marks allocated : 85

**Part C – Essay questions**

**Total marks for part C : 50**

**Answer three questions including question number one**

01. i. What are the **four** types of financial management decisions? Give an example for each type of decision on a business transaction that would be relevant? (5 Marks)
- ii. a. As a financial consultant, will you advise your client to have term deposit in a commercial bank which pays 8% interest compounded semi-annually or 8% interest compounded annually? Why? (2 Marks)
- b. A bank is offering 12% compounded yearly. If you put Rs. 1,000 in an account, how much will you have at the end of four years? (2 Marks)
- iii. a. Explain briefly the tradeoff between liquidity and profitability? (2 Marks)
- b. What is the relationship between firm value and cost of capital? (2 Marks)
- iv. a. Suppose stock in Toyota Corporation has a beta of 0.80. The market risk premium is 6%, and the risk free rate is 6%. What is Toyota's cost of equity capital. (4 Marks)
- b. In addition to the information given in the previous problem, suppose Toyota has a target debt-equity ratio of 50%. Its cost of debt is 9%, before taxes. If the tax rate is 35%, what is WACC? (3 Marks)

(Total Marks 20)

02. i. You are given following information.

State of economy	Probability of state of economy	Return on A %	Return on B %
Recession	.20	6	-20
Normal	.60	7	13
Boom	.20	11	33

- a. What is the expected return for A and for B? (Marks 3)
- b. What is the Standard Deviation for A and for B? (Marks 3)
- c. Suppose you have Rs. 200,000 total. If you put Rs.150,000 in stock A and the remainder in stock B, what will be the expected return and standard deviation of your portfolio? (Marks 5)

ii. How does the investor's preference affect the selection of optimal portfolio?

(Marks 4)

(Total Marks 15)

03. i. Suppose Janaka Corporation has decided in favor of a capital restructuring that involves increasing its existing Rs. 80 million in debt to Rs. 125 million. The interest rate on the debt is 9% and is not expected to change. The firm currently has 10 million shares outstanding, and the price per share is Rs. 45. If the restructuring is expected to increase the ROE, what is the minimum level for EBIT that Janaka Corporation's management must be expecting? Ignore taxes in your answer.

(5 Marks)

- ii. a. Briefly explain the term "Capitalization"? (2 marks)
- b. Comment on the following statement.

"Between under and over capitalization the former is the lesser evil of the two. But still both should be discouraged and the ideal should be fair capitalization."

(4 marks)

iii. "Basic problem in financing an enterprise is to maintain a sound capital structure".

Examine the statement and suggest the factors you would bear in mind while planning capital structure of a medium-sized manufacturing company.

(4 marks)

(Total Marks 15)

04. i. What are the main characteristics of preference shares?

(2 Marks)

ii. The Emerald Company has just paid a cash dividend of Rs. 2 per its common share. Investors require a 16% return from investments such as this. If the dividend is expected to grow at a steady 8% per year,

a. What is the current value of the stock?

(2 Marks)

b. What will the stock be worth in six years?

(2 Marks)

c. What would the stock sell for today if the dividend is expected to grow at 20% for the next 3 years and then settle down to 8% per years?

(4 Marks)

iii. A firm issues debentures of Rs. 100,000 and realizes Rs.98,000 after allowing 2% commission to brokers. The debentures carry an interest rate of 10%. The debentures are due for maturity at the end of the 10<sup>th</sup> year. You are required to calculate the cost of debt before tax and after tax.

(5 Marks)