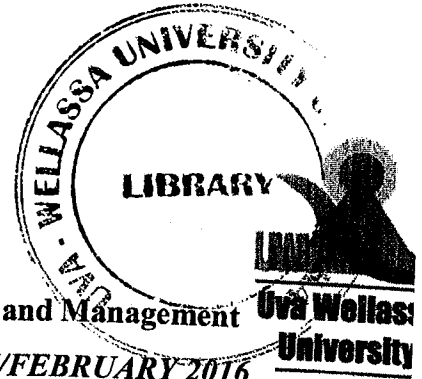


Uva Wellassa University

Faculty of Management

Degree of Bachelor of Business Management in Entrepreneurship and Management
THIRD YEAR SECOND SEMESTER EXAMINATION - JANUARY/FEBRUARY 2016

EMG 461-2 Corporate Finance



Instructions to candidates:

No. of pages : Three (03)
No. of questions : Four (04) Essay
Time : Two (02) Hours
Marks allocated : 100 Marks
Answer **all** questions.

Index No:

01.

- i) Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.
- a) Briefly explain the scope of Financial Management. (05 Marks)
 - b) How does the modern financial manager differ from the traditional financial manager? (07 Marks)
 - c) Discuss the challenges and opportunities created by internal (organizational) and external factors (macro-economic) for financial managers in Sri Lanka. (08 Marks)
- ii) Financial leverage is a two-edged sword. It multiplies good results into great results while bad results into terrible results.
- a) Differentiate the Operating Risk and Financial Risk. (05 Marks)
 - b) Explain the concept of financial leverage. Show the impact of financial leverage on the earnings per share. (07 Marks)
 - c) If the use of financial leverage magnifies the earnings per share under favorable economic conditions, why do companies not employ very large amount of debt in their capital structures? Explain (08 Marks)
- (Total Marks-40)

02.

- i) Differentiate the systematic and unsystematic risks. (04 Marks)
- ii) Explain the fundamental relationship between risk and return in well-functioning markets? (04 Marks)
- iii) You are given following information.

State of economy	Probability of state	Return on A %	Return on B %
Recession	.30	-10	10
Normal	.40	25	40
Boom	.30	50	60

- a) What is the expected return for A? for B? (04 Marks)
 - b) What is the Standard Deviation for A? for B? (04 Marks)
 - c) Suppose you have Rs.100,000 in total. If you put Rs.75,000 in stock A and the remainder in Stock B, what will be the expected return and standard deviation of your investment portfolio? (04 Marks)
- (Total Marks-20)

03.

- i) Briefly explain the relationship between firm value and cost of capital (03 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? (03 Marks)
- iii) Sunset Corporation is estimating its WACC. Its target capital structure is 20 percent debt, 20 percent preferred stock, and 60 percent common equity. Its bonds have a 12 percent coupon, paid semiannually, a current maturity of 20 years, and sell for Rs.1,000. The firm could sell, at par, Rs.100 preferred stock which pays a 12 percent annual dividend, but flotation costs of 5 percent would be incurred. Sunsets' beta is 1.2, the risk-free rate is 10 percent, and the market risk premium is 5 percent. Sunset Corporation is a constant-growth firm which just paid a dividend of Rs.2 per share, sells for Rs.27 per share, and has a growth rate of 8 percent. The firm's policy is to use a risk premium of 4 percentage points when using the bond-yield-plus-risk-premium method to find r_s . The firm's marginal tax rate is 40 percent.

You are required to calculate the Sunset Corporation's;

- a) component cost of debt (02 Marks)
- b) cost of preferred stock (02 Marks)
- c) cost of common stock (r_s) using the CAPM approach (02 Marks)
- d) cost of common stock (r_s) using the Discounted Cash Flow (DCF) approach (02 Marks)
- e) cost of common stock using the bond-yield-plus-risk-premium approach (02 Marks)
- f) Weighted Average Cost of Capital (WACC) (04 Marks)

(Total Marks-20)

04.

- i) Differentiate 'ordinary shares' from 'preference shares'? (03 Marks)
- ii) What is the Capital Asset Pricing Model(CAPM) approach for calculating the cost of equity? Briefly explain the difference between CAPM approach and the Constant Growth Approach? (04 Marks)
- iii) Zahara Corporation issues a five-year, 8% coupon bond with a face value of Rs.1,000 and coupon payments made annually. You are required to,
 - a) Determine the bond values if it is trading at the 8%, 6% and 10% yields. (03 Marks)
 - b) Comment on the price and yield relation you observe. (02 Marks)
- iv) The Amazon Corporation has just paid a cash dividend of Rs.4 per share. Investors require a 12 percent return from investments such as this. If the dividend is expected to grow at a steady 6 percent per year,
 - a) What is the current value of the stock? (02 Marks)
 - b) What will the stock be worth in four years? (02 Marks)
 - c) What would the stock sell for today if the dividend was expected to grow at 20 percent per year for next three years and then settle down to 6 percent per year, indefinitely? (04 Marks)

(Total Marks-20)

