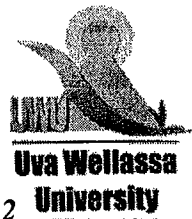


## Uva Wellassa University

Faculty of Management

Degree of Bachelor of Business Management in Entrepreneurship and Management



THIRD YEAR SECOND SEMESTER EXAMINATION - SEPTEMBER/OCTOBER 2012

EMG 461 -2 Corporate Finance

### Part C – Essay Questions

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

Marks allocation: 50 Marks

01. i. When can arise a conflict between shareholders' and managers' goals? How does wealth maximization goal take in to consideration in this conflict? (3 Marks)
- ii. If the use of financial leverage magnifies the earning per share under favorable economic conditions, why do companies not employ very large amount of debt in capital structures? Explain (3 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)
- iv. The Alto Company is considering replacing a manual production process with a machine. The money to buy the machine will be borrowed. The replacement of people with a machine will alter the firm's cost structure in favor of fixed costs, while the loan will move the capital structure in the direction of more debt. The firm's leverage positions at expected output levels with and without the project are summarized as follows.

	DOL	DFL
Current	2.0	1.5
Proposed	3.5	2.5

The economic outlook is uncertain and some managers fear a decline in sales of as much as 10% in the coming year. Evaluate the effect of the proposed project on risk in financial performance. (5 Marks)

- v. Suppose Firm A has fixed costs of Rs.1,000 per period, sells its product for Rs.10, and has variable costs of Rs.8 per unit. Further, suppose Firm B has fixed costs of Rs.1,500 and also sells its product for Rs.10 a unit. Both firms are at the same breakeven point.

What variable cost must Firm B have if it is to achieve the same breakeven point as Firm A? State the trade-off at the breakeven point. Which structure is preferred if there's a choice?

(5 Marks)

(Total Marks 20)

02. i. Giving the examples, Define systematic and unsystematic risks.

(4 Marks)

ii. You are given following information.

State of economy	Probability of state of economy	Return on A %	Return on B %
Bust	.20	-15	20
Most likely	.50	20	30
Boom	.30	60	40

a. What is the expected return for A? for B?

(Marks 3)

b. What is the Standard Deviation for A? for B?

(Marks 3)

c. Suppose you have Rs. 20,000 total. If you put Rs.15,000 in stock A and the remainder in stock B, what will be the expected return and standard deviation of your portfolio?

(Marks 5)

(Total Marks 15)

03. i. "Debt is the cheapest source of funds". Explain.

(3 Marks)

ii. The Sahara Advertising Company has a marginal tax rate of 40 percent. The last dividend paid by Sahara was Rs.0.90. Sahara's common stock is selling for Rs.8.50 per share, and its expected growth rate in earnings and dividends is 5 percent. What is Sahara's cost of common stock?

(4 Marks)

iii. An analyst has collected the following information about Galaxy Company.

- The company's capital structure is 70 percent equity, 30 percent debt.
- The yield to maturity on the company's bonds is 9 percent.
- The company's year-end dividend is forecasted to be Rs.0.80 a share.
- The company expects that its dividend will grow at a constant rate of 9 percent a year.
- The company's stock price is Rs.25.
- The company's tax rate is 40 percent.
- The company anticipates that it will need to raise new common stock this year. Its investment bankers anticipate that the total flotation cost will equal 10 percent of the amount issued. Assume the company accounts for flotation costs by adjusting the cost of capital.

Given this information, calculate the company's WACC.

(8 Marks)

(Total Marks 15)

04. i. List out some distinguishing features of debt as compared to equity?

(3 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 value of the bond's?

(5 Marks)

iii. Roland Corporation has been growing at a phenomenal rate of 30 percent per year because of its rapid expansion and explosive sales. You believe that this growth rate will last for three more years and that the rate will then drop to 10 percent per year. Then the growth rate remains at 10 percent indefinitely. Total dividends just paid were Rs. 5 million, and the required rate of return is 20 percent. What is the total value of stock?

(7 Marks)

(Total Marks 15)

