



**TECHNICAL UNIVERSITY OF MOMBASA**

**SCHOOL OF BUSINESS**

**DEPARTMENT OF ACCOUNTING & FINANCE**

**UNIVERSITY EXAMINATION FOR:**

**BACHELOR OF COMMERCE & I**

**BACHELOR OF IN BUSINESS ADMISTRATION**

**BFI 4304: CORPORATE FINANCE**

**END OF SEMESTER EXAMINATION**

**SERIES: DECEMBER, 2024**

**TIME: 2HOURS**

**DATE: DECEMBER, 2024**

**Instructions to Candidates**

You should have the following for this examination

*-Answer Booklet, examination pass and student ID*

This paper consists of **FIVE** questions. Attempt question ONE (Compulsory) and any other TWO questions.

**Do not write on the question paper.**

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**Question One**

(A) What do you understand by valuation and briefly explain any five needs for valuation

**(10 marks)**

(b) The management of Lwanda Ltd wants to establish the value of each share and has provided you with the following balance sheet.

	ksh.000
Net Fixed Assets	123,600
Inventories	38,400
Accounts receivable	28,800
Cash	7,200

Copy rights	15,000
Total Assets	215,000
Equity and liabilities;	
Equity	
Ord. Share at sh.0.50@	60,000
10% preference share Sh. 1@	15000
15% preference shares sh.80 @	13,000
Retained earnings	45,200
12% Debentures	20,000
Accounts payables	36,800
Accrued expenses	25,000
Total equity & Liabilities	215,000

Additional information:

- (i) Non-current assets can be sold at sh. 160,000,000
- (ii) Stock (inventory) can be sold for sh. 35,000,000
- (iii) Copy rights can be sold for sh. 5,000,000

Required;

Calculate the value of each ordinary share using the net Asset basis. **(10 marks)**

(c) Critically discuss various forms of Asset-based valuation stating both merits and demerits of each **(5 marks)**

(b) Discuss the limitations of the dividend growth model as a way of valuing the ordinary shares of a company. **(5 marks)**

## Question Two

(a) Anna is considering investing in a bond currently selling in the market for sh. 875.

The bond has four years to maturity, a sh.1000 face value and a 7% coupon rate. The next annual interest payment is due one year from today. The appropriate discount rate for the securities of similar risk is 10%.

### Required:

- (i) Estimate the intrinsic value of the bond. Based on the result of this estimation, should Ann purchase the bond? Explain. (5 marks)
  - (ii) Estimate the yield-to-maturity of the bond. Based on the result of this estimation, should Ann purchase the bond? Explain. (5 marks)
- (b) Briefly explain any 4 dividend theories, justifying the existence of the theory.

(10

marks)

## Question Three

Gemlo Co is a company listed on a large stock market. Extracts from its current statement of financial position are as follows:

	sh.m	sh. m
Equity Ordinary shares (sh.1 nominal)		15
Reserves		153
		-----
		168
Non-current liabilities		
6% Irredeemable loan notes	10	
7% Loan notes	12	22
		-----
		190
		-----

Gemlo Co is planning an expansion of existing business operations costing sh.10 million in the near future and is assessing its current financial position as part of preparing a business case in support of seeking new finance. The business expansion is expected to increase the profit before interest and tax of Gemlo Co by 20% in the first year. The ordinary shares of the company are currently trading at sh. 3.75 per share on an ex dividend basis. The irredeemable loan notes have a cost of debt of 7%. The 7% loan notes have a cost of debt of 6% and will be redeemed at a 5% premium to nominal value after seven years. The interest cover of Gemlo Co is 6 times. Companies operating in the same

business sector as Gemlo Co have an average debt/equity ratio of 40% on a market value basis and an average interest cover of 9 times.

**Required:**

(a) Calculate the debt/equity ratio of Gemlo Co based on market values and comment on your findings. **(8marks)**

(b) Gemlo Co agrees with a bank that its business expansion will be financed by a new issue of 8% loan notes. The company then announces to the stock market both this financing decision and the expected increase in profit before interest and tax arising from the business expansion. Required: Assuming the stock market is semi-strong form efficient, analyse and discuss the effect of the financing and profitability announcement on the financial risk and share price of Gemlo Co **(12 marks)**

**Question Four**

Argnil Co is appraising the purchase of a new machine, costing sh. 1.5 million, to replace an existing machine which is becoming out of date and which has no resale value. The forecast levels of production and sales for the goods produced by the new machine, which has a maximum capacity of 400,000 units per year, are as follows:

Year	1	2	3	4
Sales volume (units/year)	350,000	380,000	400,000	400,000

The new machine will incur fixed annual maintenance costs of sh. 145,000 per year. Variable costs are expected to be sh. 3.00 per unit and selling price is expected to be sh. 5.65 per unit. These costs and selling price estimates are in current price terms and do not take account of general inflation, which is forecast to be 4.7% per year. It is expected that the new machine will need replacing in four years' time due to advances in technology. The resale value of the new machine is expected to be sh. 200,000 at that time, in future value terms. The purchase price of the new machine is payable at the start of the first year of the four-year life of the machine. Working capital investment of sh. 150,000 will already exist at the start of the four-year period, due to the operation of the existing machine. This investment in working capital is expected to increase in nominal terms in line with the general rate of inflation. Argnil Co pays corporation tax one year in arrears at an annual rate of 27% and can claim 25% reducing balance tax-allowable depreciation on the purchase price of the new machine. The company has a real after-tax weighted average cost of capital of 6% and a nominal after-tax weighted average cost of capital of 11%.

**Required:**

(a) Using a nominal terms net present value approach, evaluate whether purchasing the new machine is financially acceptable. **(10 marks)**

(b) Discuss the reasons why investment finance may be limited, even when a company has attractive investment opportunities available to it. **(10 marks)**

**Question Five.**

(a) Two years ago your corporate treasurer purchased for the firm a 10 year bond at its par value of sh.20,000. The coupon rate on this security is 8 percent. Interest payments are made to bondholders once a year. Currently, bonds of this particular risk class are yielding investors 9 percent.

A cash shortage has forced you to instruct your treasurer to liquidate the bond.

**Required:**

a. At what price will your bond be sold? Assume annual compounding. **(5 marks)**

b. What will be the amount of your gain or loss over the original purchase price? **(5 marks)**

c. What would be the amount of your gain or loss had the treasurer originally purchased a bond with a 4-year rather than a 10 -year maturity? **(5 marks)**. (Assume all characteristics of the bonds are identical except their maturity periods.)

(d) Define the term "option " as used in financial markets **(5 marks)**