THE COOPERATIVE UNIVERSITY OF KENYA

**FACULTY COMMERCE**

Bachelor of Commerce

END OF SEMESTER EXAMINATION BCM 2206:

FINANCIAL MANAGEMENT

DATE: 19th DEC 2018 TIME: 2 Hours

INSTRUCTIONS: ANSWER QUESTION ONE AND ANY OTHER TWO QUESTIONS.

Question One A) Rudar Limited wishes to raise funds for expansion using corporate bonds.

1. What is a corporate bond? (2 marks)
2. (ii) State and explain two advantages in the use of corporate bonds. (2 marks)
3. (iii) What costs are associated with the issuing of corporate bonds? (4 Marks)
4. B) Rudar Limited has issued shs 10,000, 16% bonds redeemable at par on 1st January 2018. The bonds are dated 1st January 2007. The bonds may however be redeemed at par on 1st January 2009. Upon issue the bond will be traded on the stock market. The market rate of interest on 1st January 2007 was 14%. The market rate of interest is expected to be 10%. Required:
5. i) The issue price of the bond (4 Marks) ii) The expected market price of the bond as at 1st January 2007. (4 marks) iii) Should Rudar Limited redeem the bond on 1st January 2009? Why? (4 marks)
6. C) i. What are the disadvantages of using constant growth dividend model as a valuation model (6 marks)
7. ii. Under what circumstances is it advantageous for a lender to use zero coupon bonds? (4 marks) (Total 30 marks)

Question Two A) Explain the effect of the use of debt capital on the weighted average cost of capital of a company. (4 marks) B) Mawingu investments Ltd wishes to raise funds amounting to Shs 10 million to finance a project in the following manner: i) Shs 6 million from debt; and ii) Shs 4 million from floating new ordinary shares.

2 The present capital structure of the company is made up as follows: 1. 600,000 fully paid ordinary shares of Shs 10 each. 2. Retained earnings of Shs 4 millions 3. 200,000, 10% Preference shares of Shs 20 each. 4. 40,000 6% long term debentures of Shs 150 each. The current market price of the ordinary shares is Shs 60 per share. The expected dividend in a year’s time is Shs 2.40 per share. The average growth in earnings for both dividend and earnings has been 10% over the past ten years and this growth rate is expected to be maintained in the foreseeable future. Required:

i. Compute the component cost of:

1. Ordinary shares capital (2 marks)

2. Debt capital (2 marks)

3. Preference share capital (2 marks)

ii. Compute the company’s current weighted average cost of capital. (5 marks)

iii. Compute the company’s marginal cost of capital if I raised the additional Shs 10 million as envisaged (assume tax rate of 30%). (5 marks) (Total 20 marks)

Question Three A) Kisii Limited a bottling company is planning to undertake an expansion program. To facilitate this expansion, they intent to raise money either through a rights issue or stocks placing at the Nairobi Stock Exchange. Required: i. Explain the meaning of rights issue and list its advantages (6 marks) ii. Explain the meaning of stocks placing rights issue and list its advantages. (4 marks)

B) Explain why an economy may have an ascending yield curve (10 marks) (Total 20 marks)

Question Four: The data given below shows the capital structure of Wishani Company Limited 10% shs 1,000 debenture 4,900,000 Ordinary share capital (shs 20) 18,000,000 Retained Earnings 6,000,000 28,900,000

The structure is considered optimum and the management would wish to maintain this level. Wishani Company Limited intends to invest in a new project which is estimated to cost shs 16,800,000 with an expected net cash flow of shs 3 million per annum for 10 years. The firm has proposed to raise the required funds as follows: - 3 1. Issue 100, 10% debentures at the current market value of shs 5,000 each. 2. Utilize 60% of the existing retained earnings 3. Issue 10%, shs 20 preference shares at the current market price of shs 25 per share. 4. Issue ordinary shares at the current market price of shs 45 per share. Floatation cost is estimated to be 12% of the share value. The company’s current dividend yield is 5% which is expected to continue in the near future. Corporate tax rate is 30%. Required

a. Determine the current dividend yield per share (3 marks)

b. Determine the number of ordinary shares to be issued (2 marks)

c. Based on the information above, determine the marginal cost of capital (10 marks)

d. Why does a firm need to use depreciation as a form of financing (5 marks) (Total 20 marks)

Question Five A. Based on the traditional view, discuss the impact of capital structure on the value of a company (15marks)

B. Based on the Net Income approach, calculate the value of a firm that currently has 100,000 ordinary shares of shs 10 each with a market value of shs 50 per share. Dividend paid per share is shs 2.50. the firms perpetual net operating income is shs 100,000 per annum. The firm has also raised capital by borrowing a loan at a nominal rate of interest of 6%. Per annum. Debt constitutes 20% of the capital structure. Corporate tax is 30%. Determine the firm’s value. (5 marks). (Total 20 marks)