

**INSTITUTE OF BANKERS IN MALAWI**

**ADVANCED DIPLOMA IN BANKING EXAMINATION**

**SUBJECT: CORPORATE FINANCE (IOBM – AD 308)**

**Date: Tuesday, 24th November 2020**

**Time Allocated: 3 hours (13:30 – 16:30 Hours)**

**INSTRUCTIONS TO CANDIDATES**

1 This paper consists of **TWO** Sections, A and B.

2 Section A consists of 4 questions; each question carries 15 marks.

Answer **ALL** questions.

3 Section B consists of 4 questions; each question carries 20 marks. Answer **ANY TWO** questions.

4 You will be allowed **10 minutes** to go through the paper before the start of the examination, you may write on this paper but not in the answer book.

5 Begin each answer on a new page.

6 **Please write your examination number on each answer book used. Answer books without examination numbers will not be marked.**

7 All persons writing examinations without payment will risk expulsion from the Institute.

8 If you are caught cheating, you will be automatically disqualified in all subjects seated this semester.

9 DO NOT open this question paper until instructed to do so.

**SECTION A (60 MARKS)**

Answer **ALL** questions from this section

**QUESTION 1**

Portland Cement Ltd issued 1,000,000 shares on the market where each share was selling at MK400 and that the annual dividend payable was at MK 30 per share with expected annual growth of 2.5%. The company also issued 200,000 MK100 par value bonds on the market which were trading at MK95 with a yield of 10%. The corporate tax rate was at 30%.

**Required to;**

1. Calculate the Weighted Average Cost of Capital for the company.  *(7 marks)*
2. Calculate the cost of equity taking into consideration the annual growth of dividends. *(4 marks)*
3. Explain the **two** main demerits of WACC model as a tool for determining the cost that a firm pays for the capital used in financing its new investments. *(4 marks)*

***(Total 15 marks)***

**QUESTION 2**

1. Discuss **three** arguments for and against a rights issue of shares (*6 marks*)
2. MPICO shares plc have a beta of 0.5 and the shares of NITEL plc have a beta of 2.0. Investors have an expected rate of return of 0.3% from shares in MPICO plc and the expected returns to the market are 5%. Using the Capital Asset Pricing Model, calculate the expected rate of return for investors in NITEL plc?  *(3 marks)*
3. Explain why rights issues are normally offered at a discount to the current market value of the shares.  *(4 marks)*
4. The one-year rate of inflation is expected to be 30%. The one-year money rate of interest is 29%. Calculate the one-year real rate of interest. *(2 marks)*

**(Total 15 marks)**

**QUESTION 3**

The shareholder value concept is that the main objective of a company should be to maximize the wealth of its shareholders, and that all other objectives are subordinate to this.

**Required**

1. Explain fundamental principle underlying the concept of Shareholder Value Analysis (SVA)? *(2 marks)*
2. Discuss **two** advantages of SVA. *(4 marks)*
3. If the shareholder value concept is accepted, it follows that performance measures should focus on the creation of shareholder value. State and explain any **four** measures of performance.  *(8 marks)*

**(Total 15 marks)**

**QUESTION 4**

1. Mention **three** factors that influence the cost of capital.  *(3 marks)*
2. Teen Time Ltd requires K100 million to finance its activities. Potential shareholders require an after-tax return of 12% per annum on their investment, while its potential borrowers require 10% per annum before tax or 6.5% after tax, on a 35% tax rate.

**Required**

Evaluate the following financing option and comment on the results:

1. 100% equity raised to finance the project.
2. 80% equity and 20% debt raised to finance the project
3. 60% equity and 40% debt raised to finance the project *(12 marks)*

**(Total 15 marks)**

**SECTION B (40 MARKS)**

Answer **ANY TWO** questions from this section

**QUESTION 5**

1. Bosasa Electronics Ltd is financed by a mixture of equity and debt capital, whose market values are in the ratio 3:1. The debt capital, which is considered risk-free, yields 12% before tax. The average stock market return on equity capital is 15%. The beta value of the company’s equity capital is estimated at 0.90. The tax rate is 30%.

**Required**

What would be the appropriate cost of capital to be used for investment appraisal of new projects with the same systematic risk characteristics as the company’s current investment portfolio?  *(10 marks)*

1. Identify and discuss **three** key assumptions that underpin the use of the weighted average cost of capital as an appropriated discount rate for investment appraisal purposes. *(6 marks)*
2. Explain the difference between systematic risk and unsystematic risk. *(4 marks)*

***(Total 20 marks)***

**QUESTION 6**

1. How would you describe the working capital of a business? *(2 marks)*
2. Explain any **four** sources of working capital. *(8 marks)*
3. Suppose that a retailer buys an item from a supplier, and holds it in stock for 20 days. The retailer pays the supplier 16 days after the purchase. The item is then sold on credit to a customer, who pays for it 17 days later.

**Required**

Calculate cash cycle. *(4 marks)*

1. A company is earning insufficient cash flows from its operating activities to cover the interest payments to its lending bank.

**Required**

What effects might you expect to see in the company’s balance sheet if this situation persists? *(6 marks)*

***(Total 20 marks)***

**QUESTION 7**

1. Chilengedwe Tree Nurseries Ltd shareholders have demanded for a clear policy on they will be receiving dividends from the company in regards to the capital they supply to the company. The company should clearly stipulate how much of the firm’s earnings shall be distributed as dividends and also how much shall be retained for future growth and operations.

**Required**

1. Explain the **four** determinants to be considered when formulating the dividend policy *(8 marks)*
2. Discuss any **two** dividend theories that may be considered when formulating the dividend policy. *(4 marks)*
3. Hannover Capital Ltd have been approached by an investor who would like to continue investing in one stock only and lay-off the shares on one stock. The investor is enquiring on stock X which reported a net income of MK 15,000,000 and declared a dividend of MK0.30 per share and they invested in 10,000 common shares. Stock B reported a net income of MK20,000,000 with a declared dividend of MK0.50 per share and the investor has 12,000 common shares.

**Required**

Calculate the Dividend pay-out ratio and recommend to the investor whether to continue investing in stock A or B. Give reasons for the selected stock. *(8 marks)*

***(Total 20 marks)***

**QUESTION 8**

1. The Chief Financial Director of Zanga Phee Engineering have approved a purchase of a borehole drilling machine which costs MK120,000,000 which is expected to generate pre-tax profits from clients requiring scanning service as given below;

|  |  |
| --- | --- |
| **Year** | **Pre-tax Profit (MK)** |
| 1 | 30,000,000 |
| 2 | 22,000,000 |
| 3 | 16,000,000 |
| 4 | 21,000,000 |
| 5 | 20,000,000 |
| 6 | 15,000,000 |

Considering that Zanga Phee Engineering remits corporation tax of 30% one year in arrears and receives capital allowances on 35% reducing balance basis following a 40% first year allowance. The machine has 6-year life of which at the end will be sold for MK1,100,000 and that that the company’s after tax cost of capital is 15%;

**Required**

1. Calculate the capital allowance and tax savings over the period (*4 marks)*
2. Calculate the total tax liabilities over the period (*4 marks)*
3. Calculate the NPV for the machine (*2 marks)*
4. Recommend whether the machine should be purchased *(2* marks)

***(Total 20 marks)***

**END OF EXAMINATION PAPER**