NATIONAL UNIVERSITY OF SCIENCE AND TECHNOLOGY
FACULTY OF COMMERCE
DEPARTMENT OF FINANCE
BACHELOR OF COMMERCE HONOURS DEGREE IN FINANCE
PART IV - 2ND SEMESTER FINAL EXAMINATION -2009
CORPORATE FINANCIAL STRATEGY AND RESTRUCTURING (CFI 4201)
TIME ALLOWED: 3 HOURS

Instructions to Candidates

1 **Answer ANY four questions**
2 **All questions carry equal marks (25)**
3 **Show all workings**

QUESTION 1 (25 marks)

(a) Firms A and B are similar except that A is unlevered while B has $200 000 of 5% debentures outstanding. Assume that the corporate tax rate is 40%, Net Operating Income (NOI) is $40 000 and the cost of equity is 10%.

Required

(i) Calculate the values of the two firms if the Miller-Modigliani (MM) assumptions are met. **(4 marks)**

(ii) Suppose that the value of Firm B is $360 000. According to MM, explain whether or not these represent equilibrium values (taken together with values calculated in (i) above). If there is no equilibrium, how will equilibrium be achieved? **(6 marks)**

(b) The following are the costs and values for Firms D and C according to Ezra Solomon's traditional approach to capital structure:

	C ($)	D ($)
Total value of firm	50 000	60 000
Market value of debt	0	30 000
Market value of equity	50 000	30 000
Expected Net Operating Income	5 000	5 000
Cost of debt	0	1 800
Net Income	5 000	3 200
Cost of equity (k_e)	10.00 %	10.70 %
Debt/ Equity ratio	0	0.5
Average cost of capital (k_o)	10.60 %	8.33 %

Required

Assuming that taxes do not exist, and the equilibrium value of k_o is 9.09 %, compute the equilibrium values of Firms C and D in accordance with the MM hypothesis. **(7 marks)**

(c) Evaluate the criticism of Ezra Solomon's traditional approach to the capital structure problem. **(8 marks)**

QUESTION 2 **(25 marks)**

(a) Identify and discuss the interplay between the factors that determine the optimum dividend policy according to Walter's Dividend Relevance Model for the following types of firms:-

(i) growth firm **(6 marks)**

(ii) declining firm **(6 marks)**

(b) From a mature Zimbabwean company's perspective, examine the assumptions of Modigliani and Miller's Dividend Irrelevance Hypothesis. **(13 marks)**

QUESTION 3 **(25 marks)**

(a) Agency theory views executives as potentially risk and effort averse and sees the need for shareholders to control their actions. Discuss any five ways in which this can be done. **(10 marks)**

(b) Share options are one of the most popular incentive arrangements for directors but they have certain limitations in their ability to incentivise directors to create shareholder value. Discuss any three limitations, giving examples from Zimbabwe to validate your points. **(15 marks)**

QUESTION 4 **(25 marks)**

(a) Fafi Holdings is negotiating an acquisition of Gushungo Ltd. A disagreement has however arisen with regards to the purchase price. Specifically, the vendor is demanding the full consideration for the present value of growth opportunities, which the bidder is unwilling to pay.

Explain, giving examples, how you would structure this acquisition to resolve the bone of contention. **(10 marks)**

(b) 'To assume that an acquirer is overpaying merely because the bid price is greater than the pre-bid price is a fallacy'.
Critically analyse the above statement. **(10 marks)**

(c) Briefly discuss the trapped equity theory. **(5 marks)**

QUESTION 5 **(25 marks)**

(a) With plausible justification, provide an optimal financial strategy for Econet Wireless, a Zimbabwean telecommunications company listed on the Zimbabwe Stock Exchange. **(10 marks)**

(b) Mr. L. Ndlovu is planning to start a printing company but he has insufficient capital of his own, so he is intending to borrow the balance of the funds required (80%). He is quite hopeful that he will gain from such a capital structure, since he has heard that debt is cheaper than equity.

In this context, explain why Mr. Ndlovu's funding structure will not produce the anticipated gains and provide an alternative funding arrangement. **(15 marks)**

QUESTION 6 **(25 marks)**

(a) Loftus plc has a share price of 250 cents and earnings per share of 10 cents. Its current cost of equity is 10 %, but its steady state cost of equity (year 10) is 9.5 %. Loftus is expected to pay a dividend of 2 cents per share.

Required

(i) Assuming the P/E multiple falls to steady state in year ten, calculate the compound growth rate in EPS required to increase the share price by 9.2 % per annum up to year 10. **(5 marks)**

(ii) Assuming that the P/E multiple drops to 20 in seven years' time and all other matters remain the same, calculate the annual compound growth rate in EPS up to year seven that is required to support an annual compound growth in share price of 9.2 %. **(7 marks)**

(b) What does the share price of a company communicate and how can the directors of the company use the communication to enhance shareholder value? **(13 marks)**

END OF PAPER. GOOD LUCK!