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**INSTITUTE OF BANKERS IN MALAWI**

**ADVANCED DIPLOMA IN BANKING EXAMINATION**

**SUBJECT: CORPORATE FINANCE (IOBM – AD308)**

**Date: Friday, 3rd May 2013**

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

**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 sheets without examination numbers will not be marked.**

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

**SECTION A (60 MARKS)**

Answer **ALL** questions from this section

**QUESTION 1**

Explain **five** key functions of Corporate Finance. **(Total 15 marks)**

**QUESTION 2**

(a) Define the term Accounting Rate of Return (ARR)andexplain how it is used in capital investment appraisal. *(3 marks)*

(b) Apart from ARR, name any **four** other methods that can be used in capital investment appraisal. *(4 marks)*

(c) A project has an initial cost of investment of MK25,000,000. It is expected to produce the following cash inflows:

Year 1 MK 3,000,000

Year 2 MK 4,500,000

Year 3 MK 9,000,000

Year 4 MK11,000,000

No scrap value is expected. The cost of capital is expected to be 9% over the four years.

**Required:**

Identify the most suitable capital investment appraisal technique and advise whether the project should be accepted.  *(8 marks)*

**(Total 15 marks)**

**QUESTION 3**

1. There are **two** elements of risk attached to any security: systematic (market) and unsystematic (specific).

**Required**:

Explain the difference between these **two** elements of risk. Use a diagram to enhance your argument(s) *(10 marks)*

1. In what way does Capital Asset Pricing Model (CAPM) use the systematic risk of individual securities*? (3 marks)*
2. List any **two** areas of application of CAPM. *(2 marks)*

**(Total 15 marks)**

**QUESTION 4**

1. Mergers and acquisitions (M & As) are often categorized as horizontal merger, vertical merger and conglomerate merger or diversification.

**Required:**

Briefly explain what each of these **three** terms mean in the classification of acquisitions.

*(6 marks)*

1. Acquisition motives may be defined in terms of the acquirer’s corporate and business strategy objectives.

**Required:**

State any **six** main reasons for a decision of one organization to merge with another organization. *(9 marks)*

**(Total 15 marks)**

**SECTION B (40 MARKS)**

Answer **ANY TWO** questions from this section

**QUESTION 5**

(a) Briefly explain what you understand by the term Capital Rationing and mention the difference between **two** types of Capital Rationing*. (5 marks)*

(b) The management of Lobina Limited have found that for the following year the company has only MK100,000,000 for investment. The company’s cost of capital is 20%. They are currently considering four independent and divisible projects, as set out in the following table:

**Project Investment Required NPV at 20%**

MK

W 100,000,000 48,000,000

X 20,000,000 16,000,000

Y 30,000,000 18,000,000

Z 45,000,000 21,000,000

**Required:**

How should Lobina Limited proceed? Explain using appropriate calculations and justify your choice. *(15 marks)*

**(Total 20 marks)**

**QUESTION 6**

Suppose Tayamba Bwino Holdings have two investments (A and B) with the following probability distributions:

**Economic outlook Investment A Investment B**

**Return Probability Return Probability**

Best outcome

(Boom) 5% 0.2 7% 0.2

Most likely outcome

(Growth) 15% 0.6 14% 0.6

Worst outcome

(Slump) 25% 0.2 21% 0.2

**Required:**

Show the effect of perfect positive and perfect negative correlation between the two investments, assuming the portfolio comprises 40 percent Investment A and 60 percent Investment B.

*Additional notes*

1. To calculate the **standard deviation of a portfolio which contains two investments,** you may use the following formula:

S = √ ( x1)2 δ12+(x2)2δ22+2( x1)(x2)(c)( δ1) (δ2)

**where:**

S = the standard deviation of the portfolio

X1 = the weighting applying to the first investment

X2 = the weighting applying to the second investment

δ1 = the standard deviation of the first investment

δ2 = the standard deviation of the second investment

c = the correlation coefficient between the investments

*Alternatively,*

1. For **Standard deviation of a two-asset portfolio (**δp**)**

The formula is as follows

δp = √a2δ2A+(1+a)2δ2B+2a(1-a)cov(RA,RB)

**where:**

a = Proportion of investment in A

δp = Portfolio standard deviation

δ2A = Variance of investment A

δ2B = Variance of investment B

Cov (RA,RB) = Covariance of A and B **(Total 20 marks)**

**QUESTION 7**

Discuss **any five** of the following factors affecting Dividend Policy under the following headings:

1. Legal constraints *(4 marks)*
2. Growth prospects *(4 marks)*
3. Market considerations *(4 marks)*
4. The clientele effect *(4 marks)*
5. Signalling *(4 marks)*
6. Agency considerations *(4 marks)*
7. Dividend payments (interim and final) *(4 marks)*

**(Total 20 marks)**

**QUESTION 8**

Bwanamkubwa Traders Limited has the following capital structure:

|  |  |
| --- | --- |
| **Equity:** | 2,000,000 MK2 ordinary shares, market price MK2.50 |
| **Preference:** | 1,000,000 12% MK1 preference shares, market price MK1.20 |
| **Reserves:** | MK1,500,000 |
| **Bank loan:** | MK500,000 15% bank loan |
| **Debentures:** | MK1,750,000 16% Debentures, market price 110 |

You are advised that the current and expected future rate of ordinary share dividend is 20% and the company tax rate is 33%.

**Required:** Calculate the firm’s weighted average cost of capital. Show all your workings.

**(Total 20 marks)**

**END OF EXAMINATION PAPER**