

THE OPEN UNIVERSITY OF SRI LANKA
COMMONWEALTH EXECUTIVE MASTER OF BUSINESS/PUBLIC
ADMINISTRATION
FINAL EXAMINATION – MARCH 2006
MCP 2610 – CORPORATE FINANCE
DURATION : THREE (03) HOURS



Date : 22nd April 2006

Time: 9.30 a.m. 12.30 p.m.

Answer Seven (7) Questions in all, selecting One (1) Question from Each Part, (PARTS A-G).
 Non-programmable calculators are allowed.

Any assumptions should be clearly stated

Graph paper and PV Tables will be provided.

PART A

1. "In business strategy formulation Corporate Finance plays a significant role". Discuss.
(15 Marks)
2. Define the term " financial intermediation." and discuss its significance in the modern economy.
(15 Marks)

PART B

3. Write short notes on any four (4) of the following

(a) Liquidity Ratio	(e) Matching
(b) Leverage	(f) Cash Acquisition
(c) Convertible Debentures	(g) Stock Dividend
(d) Political Risk	

 (10 marks)
4. Compare and Contrast any four (4) of the following

(a) Operating vs Financial Leasing
(b) Merger vs Acquisition
(c) Forward vs Future Contracts
(d) Call Price vs Conversion Price
(e) Expectations Theory vs Market-Segmentation Theory
(f) Technical Insolvency vs Legal Insolvency
(g) Systematic Risk vs Unsystematic Risk
(h) Primary Market vs Secondary Market

 (10 Marks)

PART C

5. Indicate whether the following statements are correct or not. Do not repeat the question in your answer script. Incorrect answers will carry Negative (-) marks.
 - (a) "Market Interest Rate depends on the Inflation Rate."
 - (b) " A Right Issue will lead to a dilution in ownership."
 - (c) " Firms carrying heavy equipment should have a high profit margin."

- (d) "Operating gearing is defined as the extent to which debts are used in finance mix."
- (e) "Trade Credit has an explicit interest rate cost."
- (g) "The probability distribution of a less risky expected return is flatter than that of a risky return."
- (h) "A new share issue will always increase share capital of a company."
- (i) "Cost of retained earnings have a zero cost."

(16 Marks)

PART D

6. (a) Explain briefly "Exchange Risk" and how a Forward Contract would help to mitigate exchange risk?
- (b) The spot exchange of GBP is 1.8632/1US\$
The three- month forward rate is 1.8586/1US
Calculate the forward discount in annual terms

(10 Marks)

7. Anuradha Ltd requires additional funds for expansion in the next year and has approached you. You ascertain the following;

- Additional funding required: Rs. 500,000
- Issued Share Capital (Rs 10/= each) Rs 100,000
- Current Market Share Price (Rs 20/= each)
- Market Interest Rate 12% p.a
- Tax Rate 30%
- The estimated additional profit (EBIT) Rs. 150,000.(This could, however, be higher or lower, depending on the market conditions).

Advise the Chairman of the company.

(10 marks)

PART E

8. Perakum Ltd. has warrants outstanding with a balance expiry period of 3 years. Each warrant entitles the holder to purchase 1 ordinary share price of Rs. 40 per share.
- Determine the formula value and premium over the formula value if the respective prices of ordinary shares and warrants are:
- (a) Rs. 40/= per share and Rs. 3.50 per warrant
 - (b) Rs. 32 per share and Rs. 1.50 per warrant
 - (c) Rs. 32 per share and Rs. 9.50 per warrant

(14Marks)

9. (a) What is an Option?
- (b) In February you purchased a 3-month call option on SB Ltd shares, at a premium of Rs. 5.00 per share, with an exercise price of Rs. 45. If the current market price of the share is Rs. 64.00 and you decide to exercise your rights what will be the outcome? If, on the contrary, if the share price drops to Rs. 32.00 what will be your decision?

(14 Marks)

PART F

10. The summary Balance Sheet of Ben Fit Ltd as at 31 March 2005 is given below.

Ben Fit Ltd.			
<u>Balance Sheet as at 31st March 2005</u>			
	(Rs'000)		(Rs'000)
Share Capital		Fixed Assets	80,000
8% Preference Shares, 500,000 of Rs. 10 each	5,000		
Ordinary Shares 5,000,000 of Rs. 10 each	50,000		
Revenue Reserves	<u>65,000</u>		
	120,000		
Current Liabilities	<u>40,000</u>	Current Assets	<u>80,000</u>
	<u>160,000</u>		<u>160,000</u>

The Company's Earnings Before Interest and Tax for the Year Ended 31 March 2005: Rs 12.00 Mn.

Calculate:

- (a) EPS of Ordinary Shares
- (b) Value of Preference Shares on Dividend Yield basis
- (c) Value of Ordinary Shares on: (i) Dividend Yield basis (ii) Earnings Yield basis

Note: (1) Average Rate of Dividends on Ordinary Shares of Ben Fit Ltd. for the last three years : 15%; Dividend Yield on similar shares is 12%; (2) Preference dividends of comparable business : 6%.

(15 Marks)

11. R Ltd and S Ltd have the following data

	R Ltd	S Ltd
No. of shares issued	20,000	15,000
EAIT (Rs)	80,000	50,000
Market Price per share (Rs).	36.00	40.00
EPS	Rs. 4.00	Rs. 3.33
P/E Ratio	9X	12X

If R Ltd acquired the shares of S Ltd by 1:1 exchange of shares, what will be the effect on EPS for R Ltd's shareholders?

(15 Marks)

PART G

12. Paradise Foods Ltd. owns and operates a chain of super markets in Sri Lanka. The market chain has expanded over the last three years mainly through their acquisition strategy. The directors of the company wish to conduct a financial review before embarking on any further expansion, for which you have been appointed by the Board of Directors of the Company.

You are required to :

- (a) carry out a comprehensive financial analysis, based on the information given below

- (b) interpret the financial ratios which you consider will reflect the company's financial performance and condition
- (c) report to the board on your findings, highlighting (i) any limitations of your financial analysis, (ii) any further information (financial and non-financial) which you would think would be helpful to your analysis, (iii) appropriate recommendations based on your analysis

Abridged Profit and Loss Statement

For the year ended 31 March	2005	2006
	(Rs M)	(RsM)
Net Sales	1120	1400
Cost of Sales	<u>760</u>	<u>950</u>
Gross Profit	360	450
Interest	2	10
Operating Expenses	<u>198</u>	<u>205</u>
Earnings Before Tax	160	235
Taxation	<u>80</u>	<u>110</u>
Earnings After Tax	<u>80</u>	<u>125</u>
Balance Sheet as at 31 March	2005	2006
	(Rs M)	(Rs M)
Share Capital (500,000 shares of Rs. 10 each)	50	50
Share Premium	50	50
Revenue Reserves	<u>270</u>	<u>320</u>
	370	420
Long Term Liabilities	<u>20</u>	<u>113</u>
	390	533
Current Liabilities		
Trade Creditors	90	100
Taxation	50	60
Accrued Expenses	<u>90</u>	<u>107</u>
	<u>620</u>	<u>800</u>
	(Rs M)	(Rs M)
Fixed Assets at Cost	320	340
Depreciation	<u>(200)</u>	<u>(210)</u>
	<u>120</u>	<u>130</u>
Current Assets		
Stocks	130	210
Debtors	170	230
Cash	<u>200</u>	<u>230</u>
	<u>500</u>	<u>670</u>
Total Assets	<u>620</u>	<u>800</u>

(20 Marks)

APPENDIX: TABLES

Table 1
Present Value of Re. 1 = $1/(1+r)^n$

Year	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.789	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149
21	0.811	0.660	0.538	0.439	0.359	0.294	0.242	0.199	0.164	0.135
22	0.803	0.647	0.522	0.422	0.342	0.278	0.226	0.184	0.150	0.123
23	0.795	0.634	0.507	0.406	0.326	0.262	0.211	0.170	0.138	0.112
24	0.788	0.622	0.492	0.390	0.310	0.247	0.197	0.158	0.126	0.102
25	0.780	0.610	0.478	0.375	0.295	0.233	0.184	0.146	0.116	0.092
26	0.772	0.598	0.464	0.361	0.281	0.220	0.172	0.135	0.106	0.084
27	0.764	0.586	0.450	0.347	0.268	0.207	0.161	0.125	0.098	0.076
28	0.757	0.574	0.437	0.333	0.255	0.196	0.150	0.116	0.090	0.069
29	0.749	0.563	0.424	0.321	0.243	0.185	0.141	0.107	0.082	0.063
30	0.742	0.552	0.412	0.308	0.231	0.174	0.131	0.099	0.075	0.057

Table 1
Present Value of Re. 1 = $1/(1+r)^n$

Year	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.080	0.069	0.060	0.052
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.059	0.051	0.044
18	0.153	0.130	0.111	0.095	0.081	0.069	0.060	0.051	0.043	0.037
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026
21	0.112	0.093	0.077	0.064	0.053	0.044	0.037	0.031	0.026	0.022
22	0.101	0.083	0.068	0.056	0.046	0.038	0.032	0.026	0.022	0.018
23	0.091	0.074	0.060	0.049	0.040	0.033	0.027	0.022	0.018	0.015
24	0.082	0.066	0.053	0.043	0.035	0.028	0.023	0.019	0.015	0.013
25	0.074	0.059	0.047	0.038	0.030	0.024	0.020	0.016	0.013	0.010
26	0.066	0.053	0.042	0.033	0.026	0.021	0.017	0.014	0.011	0.009
27	0.060	0.047	0.037	0.029	0.023	0.018	0.014	0.011	0.009	0.007
28	0.054	0.042	0.033	0.026	0.020	0.016	0.012	0.010	0.008	0.006
29	0.048	0.037	0.029	0.022	0.017	0.014	0.011	0.008	0.006	0.005
30	0.044	0.033	0.026	0.020	0.015	0.012	0.009	0.007	0.005	0.004

Table 1
Present Value of Re. $1 = 1/(1 + r)^n$

Year	21%	22%	23%	24%	25%	26%	27%	28%	29%	30%
1	0.826	0.820	0.813	0.806	0.800	0.794	0.787	0.781	0.775	0.769
2	0.683	0.672	0.661	0.650	0.640	0.630	0.620	0.610	0.601	0.592
3	0.564	0.551	0.537	0.524	0.512	0.500	0.488	0.477	0.466	0.456
4	0.467	0.451	0.437	0.423	0.410	0.397	0.384	0.373	0.361	0.351
5	0.386	0.370	0.355	0.341	0.328	0.315	0.303	0.291	0.280	0.270
6	0.319	0.303	0.289	0.275	0.262	0.250	0.238	0.227	0.217	0.207
7	0.263	0.249	0.235	0.222	0.210	0.198	0.188	0.178	0.168	0.159
8	0.218	0.204	0.191	0.179	0.168	0.157	0.148	0.139	0.130	0.121
9	0.180	0.167	0.155	0.144	0.134	0.125	0.116	0.108	0.101	0.093
10	0.149	0.137	0.126	0.116	0.107	0.099	0.092	0.085	0.078	0.071
11	0.123	0.112	0.103	0.094	0.086	0.079	0.072	0.066	0.061	0.056
12	0.102	0.092	0.083	0.076	0.069	0.062	0.057	0.052	0.047	0.043
13	0.084	0.075	0.068	0.061	0.055	0.050	0.045	0.040	0.037	0.033
14	0.069	0.062	0.055	0.049	0.044	0.039	0.035	0.032	0.028	0.025
15	0.057	0.051	0.045	0.040	0.035	0.031	0.028	0.025	0.022	0.019
16	0.047	0.042	0.036	0.032	0.028	0.025	0.022	0.019	0.017	0.015
17	0.039	0.034	0.030	0.026	0.023	0.020	0.017	0.015	0.013	0.011
18	0.032	0.028	0.024	0.021	0.018	0.016	0.014	0.012	0.010	0.009
19	0.027	0.023	0.020	0.017	0.014	0.012	0.011	0.009	0.008	0.007
20	0.022	0.019	0.016	0.014	0.012	0.010	0.008	0.007	0.006	0.005
21	0.018	0.015	0.013	0.011	0.009	0.008	0.007	0.006	0.005	0.004
22	0.015	0.013	0.011	0.009	0.007	0.006	0.005	0.004	0.004	0.003
23	0.012	0.010	0.009	0.007	0.006	0.005	0.004	0.003	0.003	0.002
24	0.010	0.008	0.007	0.006	0.005	0.004	0.003	0.003	0.002	0.002
25	0.009	0.007	0.006	0.005	0.004	0.003	0.003	0.002	0.002	0.001
26	0.007	0.006	0.005	0.004	0.003	0.002	0.002	0.002	0.001	0.001
27	0.006	0.005	0.004	0.003	0.002	0.002	0.002	0.001	0.001	0.001
28	0.005	0.004	0.003	0.002	0.002	0.002	0.001	0.001	0.001	0.001
29	0.004	0.003	0.002	0.002	0.002	0.001	0.001	0.001	0.001	0.001
30	0.003	0.003	0.002	0.002	0.001	0.001	0.001	0.001	0.000	0.000