



Send up Exam 2071

Subject: **Capital Structure Management - 1 (FIN 632)**

Grade: **MBS /II Year/MGMT**

Time: 4:00 hrs.

F.M.: 100

P.M.: 35

*Candidates are required to give their answers in their words as far as practicable.*

**Group A**  
**(Short Answer Questions)**

**60**

**Attempt any SIX questions. The questions are of equal value.**

1. Protective covenants of loan agreement may be grouped into general provisions, routine provisions and special provisions. Discuss what are these protective covenants.
2. Discuss the advantages and disadvantages of preferred stock from an issuer's viewpoint and investor's viewpoint.
3. K-Mall is expanding its chain of retail stores. This program will require a capital expenditure of Rs.3 million, which must be financed. The company has settled on a 3-year revolving credit of Rs.3 million, which may be converted into a 3-year term loan, at the expiration of the revolving credit commitment. The commitment fee for both credit arrangements is 1 percent of the unused portions. The bank has quoted the firm an interest rate of 2 percent over prime for the revolving credit and 3 percent over prime for the term loan, if that option is taken. The company expects to borrow Rs 1.4 million at the outset and another Rs 1.6 million at the very end of the first year. At the expiration of the revolving credit, the company expects to take down the full term loan.

At the end of the fourth, fifth, and sixth years, it expects to make principal payments of Rs 1 million.

- (a) For each of the next 6 years, what is the expected commitment fee in rupees?
  - (b) What is the expected rupee interest cost above the prime rate?
4. National Construction Company of Nepal is faced with the decision of whether it should purchase or lease a new backhoe loader. The loader can be leased on an eight-year contract for Rs.6 million a year or it can be purchased for Rs.30 million. The salvage value of the equipment after eight years is Rs.2.8 million. The firm uses straight-line depreciation. The discount rate applied is its after-tax cost of debt. The company can borrow at 15 percent and has a 30 percent marginal tax rate and a 12 percent cost of capital. Analyze the lease versus purchase decision using the firm's after-tax cost of debt as the discount factor.
  5. Miss J. Sharma's total assets consist of 100 shares of Nepal Oil Limited and Rs.10,000 in cash. The bank now offers one additional share at a price of Rs.80 for each four shares held. The current market price of the stock is Rs.120.
    - (a) Calculate the value of a right. Also prepare a statement to show her total assets before the offering.
    - (b) Prepare statements to show total assets after the offering for each of the following alternative courses of action.
      - (i) She exercises all his rights.
      - (ii) She sells all his rights.
      - (iii) She sells 60 rights and exercises 40 rights
      - (iv) She neither sells for nor exercises the rights.
  6. The common stock of the Electricity Corporation of Nepal earns Rs. 2.50 per share, has a dividend payout of two thirds, and sells at a price earning ratio of 16. The corporation wishes to offer Rs. 10 million of 9 percent, 20-year convertible debentures with an initial conversion premium of 20 percent and a call price of 105. The company currently has one million common shares outstanding and has a 50 percent tax rate.
    - (i) What is the conversion price?

- (ii) What is the conversion ratio per Rs. 1000 debenture.
  - (iii) What is the initial conversion value of each debenture.
  - (iv) How many new shares of common must be issued if all debentures are converted?
7. Nepal Tobacco Company has Rs. 1 million in earnings before interest and taxes. Currently, it is all equity financed. It may issue Rs. 3 million in perpetual debt at 15 percent interest in order to repurchase stock, thereby recapitalizing the corporation. There are no personal taxes.
- (i) If the corporate tax rate is 40 percent, what is the income to all security holders if the company remains all equity financed? If it is recapitalized?
  - (ii) What is the present value of the debt tax shield?
  - (iii) The equity capitalization rate of the company's stock is 20 percent while it remains all equity financed. What is the value of the firm? What is the value if it is recapitalized?
8. Write notes on (Any two):
- (a) Warrants
  - (b) Convertibles
  - (c) Home-made dividends

### **Group B**

#### **Comprehensive Answer Questions** **Attempt any TWO questions.**

**40**

9. Discuss the position of Modigliani and Miller on the issue of optimal capital structure.
10. Nepal Livestock Limited has a Rs. 50 million long-term 15-year bond issue outstanding, which has a 12 percent annual coupon and 10 years remaining to maturity. This issue, which was sold 5 years ago, had floatation costs of Rs.2.5 million, which the firm has been amortizing on a straight-line basis over the 15-year original life of the issue. The bond has a call provision, which makes it possible for the company to retire the bonds at this time by calling them in at a 9 percent call

premium. Investment bankers have assured the company that it could sell an additional Rs. 50 million to Rs. 60 million worth of new annual coupon 10-year bonds at an interest rate of 10 percent. To ensure that the funds required to pay off the old debt will be available, the new bonds would be sold one month before the old issue is called, so for one month, interest would have to be paid on two issues. Current short-term interest rates are 8 percent; for the one-month overlap period, proceeds from the new issue will be invested in short-term securities. Predictions are that long-term interest rates are unlikely to fall below 10 percent. Floatation costs on a new refunding issue would amount to Rs.2 million. The company's marginal tax rate is 40 percent. The after-tax cost of debt is used as a discount factor in the analysis. Should the company refund old high yielding issue and replace it by new low yielding bonds?

11. The Kosi Rice Company is currently valued at Rs.500,000. Seventy percent of current value is the face value of pure discount debt, all of which will mature in four years. The variance of percentage returns is 56.25 percent. The risk-free rate is 12 percent.
- (a) Determine the market value of the equity.
  - (b) Determine the market value of the debt.
  - (c) What is the yield to maturity on the debt?