<u>Chapter 14</u>

Level I

E14.7 *Time allowed – 45 minutes*

Raisin-Kash plc currently earns a profit after tax of 7% on capital employed and has the following capital structure:

1,000,000 ordinary shares of £1	£1,000,000
Retained earnings	£900,000

In order to invest in some new profitable projects the company wishes to raise £504,000 from a rights issue.

(i) If the current ordinary share price is £2.40 advise the company of the number of shares that must be issued if the rights price is £2.25; £1.90; £1.80; £1.60, per share.

(ii) Assume that

- **(a) the company decided to raise its new equity capital by a 1 for 4 share rights issue at a price of £1.90**
- **(b) the market price was £2.20 on 30 September**
- **(c) immediately the company announced the rights issue the price fell to below £2 on 1 October**
- **(d) the share price recovered just before the issue was due to be made to £2.10 per share, the cum rights price**

and calculate the theoretical ex rights price, the new market price, as a consequence of an adjustment to allow for the discount price of the new issue.

(Note: The *cum rights* price means the price at which the shares are traded with the rights included.)

Level II

E14.8 *Time allowed – 90 minutes*

Percival plc is financed by £0.50 ordinary share capital and irredeemable debentures. The debentures carry a nominal rate of 9% and have a current market value at par. The company has paid an annual dividend of 15p per ordinary share in the past and is expected to continue to do so in the future. The market value per share is £1.20 ex dividend. The total market value of equity is £10,000000. The total market value of debentures is £1,000,000.

Percival plc is now considering a major new project, which will cost £1,500,000 and return annual net cash flows in perpetuity of £200,000 (before interest). Percival plans to finance the project with a new issue of 9% debentures at par. The rights of existing debenture holders would be protected and so it is expected that the cost of existing debt will remain unchanged as will its market value.

The returns from the new project carry the same level of risk as the returns from existing projects so the business risk of the company as a whole is unaffected. Therefore there should be no increase in the company cost of capital to allow for an additional business risk element. However, the higher gearing will increase the financial risk for the shareholders.

If the project and its method of financing receives the approval of the board of directors of Percival plc there will be an increase of 3% in the cost of equity.

You should ignore taxation and assume that earnings before interest will be paid out in interest and dividends in the year they are received.

(i) Recommend to Percival plc whether or not they should undertake the project.

(ii) Calculate how much the choice in method of financing affects you recommendation.

(Hint: the discounted cash flow of a sum in perpetuity is the annual value divided by the discount rate).