

## PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

### QUESTIONS

#### Merger and Acquisitions

1. ABC Co. is considering a new sales strategy that will be valid for the next 4 years. They want to know the value of the new strategy. Following information relating to the year which has just ended, is available:

| Income Statement                                     | ₹      |
|------------------------------------------------------|--------|
| Sales                                                | 20,000 |
| Gross margin (20%)                                   | 4,000  |
| Administration, Selling & distribution expense (10%) | 2,000  |
| PBT                                                  | 2,000  |
| Tax (30%)                                            | 600    |
| PAT                                                  | 1,400  |
| Balance Sheet Information                            |        |
| Fixed Assets                                         | 8,000  |
| Current Assets                                       | 4,000  |
| Equity                                               | 12,000 |

If it adopts the new strategy, sales will grow at the rate of 20% per year for three years. The gross margin ratio, Assets turnover ratio, the Capital structure and the income tax rate will remain unchanged.

Depreciation would be at 10% of net fixed assets at the beginning of the year.

The Company's target rate of return is 15%.

Determine the incremental value due to adoption of the strategy.

#### Foreign Exchange Risk Management

2. Bharat Silk Limited, an established exporter of silk materials, has a surplus of US\$ 20 million as on 31st May 2015. The banker of the company informs the following exchange rates that are quoted at three different forex markets:

|           |        |             |
|-----------|--------|-------------|
| GBP/ INR  | 99.10  | at London   |
| INR/ GBP  | 0.01   | at London   |
| USD/ INR  | 64.10  | at Mumbai   |
| INR/ US\$ | 0.02   | at Mumbai   |
| USD/ GBP  | 0.65   | at New York |
| GBP/ USD  | 1.5530 | at New York |

Assuming that there are no transaction costs, advice the company how to avail the arbitrage gain from the above quoted spot exchange rates.

3. On January 28, 2010 an importer customer requested a bank to remit Singapore Dollar (SGD) 25,00,000 under an irrevocable LC. However, due to bank strikes, the bank could effect the remittance only on February 4, 2010. The interbank market rates were as follows:

|                | January, 28          | February 4    |
|----------------|----------------------|---------------|
| Bombay US\$1   | = ₹ 45.85/45.90      | 45.91/45.97   |
| London Pound 1 | = US\$ 1.7840/1.7850 | 1.7765/1.7775 |
| Pound 1        | = SGD 3.1575/3.1590  | 3.1380/3.1390 |

The bank wishes to retain an exchange margin of 0.125%. How much does the customer stand to gain or lose due to the delay? (Calculate rate in multiples of .0001)

#### Mutual Funds

4. A mutual fund made an issue of 10,00,000 units of ₹ 10 each on January 01, 2008. No entry load was charged. It made the following investments:

| Particulars                                | ₹                |
|--------------------------------------------|------------------|
| 50,000 Equity shares of ₹ 100 each @ ₹ 160 | 80,00,000        |
| 7% Government Securities                   | 8,00,000         |
| 9% Debentures (Unlisted)                   | 5,00,000         |
| 10% Debentures (Listed)                    | <u>5,00,000</u>  |
|                                            | <u>98,00,000</u> |

During the year, dividends of ₹ 12,00,000 were received on equity shares. Interest on all types of debt securities was received as and when due. At the end of the year equity shares and 10% debentures are quoted at 175% and 90% respectively. Other investments are at par.

Find out the Net Asset Value (NAV) per unit given that operating expenses paid during the year amounted to ₹ 5,00,000. Also find out the NAV, if the Mutual fund had distributed a dividend of ₹ 0.80 per unit during the year to the unit holders.

#### Security Analysis

5. G holds securities as detailed herein below:

| Security    | Face Value (₹) | Numbers | Coupon Rate (%) | Maturity Years | Annual Yield (%) |
|-------------|----------------|---------|-----------------|----------------|------------------|
| (i) Bond A  | 1,000          | 100     | 9               | 3              | 12               |
| (ii) Bond B | 1,000          | 100     | 10              | 5              | 12               |

|                           |     |       |    |   |     |
|---------------------------|-----|-------|----|---|-----|
| (iii) Preference Shares C | 100 | 1,000 | 11 | * | 13* |
| (iv) Preference Shares C  | 100 | 1,000 | 12 | * | 13* |

\* Likelihood of being called (redeemed) at a premium over par.

Compute the current value of G's portfolio.

6. Capital structure of Sun Ltd., as at 31.3.2003 was as under:

|                             | (₹ in lakhs) |
|-----------------------------|--------------|
| Equity share capital        | 80           |
| 8% Preference share capital | 40           |
| 12% Debentures              | 64           |
| Reserves                    | 32           |

Sun Ltd., earns a profit of ₹ 32 lakhs annually on an average before deduction of income-tax, which works out to 35%, and interest on debentures.

Normal return on equity shares of companies similarly placed is 9.6% provided:

- (a) Profit after tax covers fixed interest and fixed dividends at least 3 times.
- (b) Capital gearing ratio is 0.75.
- (c) Yield on share is calculated at 50% of profits distributed and at 5% on undistributed profits.

Sun Ltd., has been regularly paying equity dividend of 8%.

Compute the value per equity share of the company.

7. GHI Ltd., AAA rated company has issued, fully convertible bonds on the following terms, a year ago:

|                                              |                             |
|----------------------------------------------|-----------------------------|
| Face value of bond                           | ₹ 1000                      |
| Coupon (interest rate)                       | 8.5%                        |
| Time to Maturity (remaining)                 | 3 years                     |
| Interest Payment                             | Annual, at the end of year  |
| Principal Repayment                          | At the end of bond maturity |
| Conversion ratio (Number of shares per bond) | 25                          |
| Current market price per share               | ₹ 45                        |
| Market price of convertible bond             | ₹ 1175                      |

AAA rated company can issue plain vanilla bonds without conversion option at an interest rate of 9.5%.

Required: Calculate as of today:

- (i) Straight Value of bond.
- (ii) Conversion Value of the bond.
- (iii) Conversion Premium.
- (iv) Percentage of downside risk.
- (v) Conversion Parity Price.

| t                 | 1      | 2      | 3      |
|-------------------|--------|--------|--------|
| $PVIF_{0.095, t}$ | 0.9132 | 0.8340 | 0.7617 |

8. Closing values of BSE Sensex from 6th to 17th day of the month of January of the year 200X were as follows:

| Days | Date | Day | Sensex     |
|------|------|-----|------------|
| 1    | 6    | THU | 14522      |
| 2    | 7    | FRI | 14925      |
| 3    | 8    | SAT | No Trading |
| 4    | 9    | SUN | No Trading |
| 5    | 10   | MON | 15222      |
| 6    | 11   | TUE | 16000      |
| 7    | 12   | WED | 16400      |
| 8    | 13   | THU | 17000      |
| 9    | 14   | FRI | No Trading |
| 10   | 15   | SAT | No Trading |
| 11   | 16   | SUN | No Trading |
| 12   | 17   | MON | 18000      |

Calculate Exponential Moving Average (EMA) of Sensex during the above period. The 30 days simple moving average of Sensex can be assumed as 15,000. The value of exponent for 30 days EMA is 0.062.

Give detailed analysis on the basis of your calculations.

### International Capital Budgeting

9. A multinational company is planning to set up a subsidiary company in India (where hitherto it was exporting) in view of growing demand for its product and competition from other MNCs. The initial project cost (consisting of Plant and Machinery including

installation) is estimated to be US\$ 500 million. The net working capital requirements are estimated at US\$ 50 million. The company follows straight line method of depreciation. Presently, the company is exporting two million units every year at a unit price of US\$ 80, its variable cost per unit being US\$ 40.

The Chief Financial Officer has estimated the following operating cost and other data in respect of proposed project:

- (i) Variable operating cost will be US \$ 20 per unit of production;
- (ii) Additional cash fixed cost will be US \$ 30 million p.a. and project's share of allocated fixed cost will be US \$ 3 million p.a. based on principle of ability to share;
- (iii) Production capacity of the proposed project in India will be 5 million units;
- (iv) Expected useful life of the proposed plant is five years with no salvage value;
- (v) Existing working capital investment for production & sale of two million units through exports was US \$ 15 million;
- (vi) Export of the product in the coming year will decrease to 1.5 million units in case the company does not open subsidiary company in India, in view of the presence of competing MNCs that are in the process of setting up their subsidiaries in India;
- (vii) Applicable Corporate Income Tax rate is 35%, and
- (viii) Required rate of return for such project is 12%.

Assuming that there will be no variation in the exchange rate of two currencies and all profits will be repatriated, as there will be no withholding tax, estimate Net Present Value (NPV) of the proposed project in India.

Present Value Interest Factors (PVIF) @ 12% for five years are as below:

| Year | 1      | 2      | 3      | 4      | 5      |
|------|--------|--------|--------|--------|--------|
| PVIF | 0.8929 | 0.7972 | 0.7118 | 0.6355 | 0.5674 |

### Leasing

10. P Ltd. has decided to acquire a machine costing ₹ 50 lakhs through leasing. Quotations from 2 leasing companies have been obtained which are summarised below:

|                                                  | Quote A | Quote B |
|--------------------------------------------------|---------|---------|
| Lease term                                       | 3 years | 4 years |
| Initial lease rent (₹ lakhs)                     | 5.00    | 1.00    |
| Annual lease rent (payable in arrears) (₹ lakhs) | 21.06   | 19.66   |

P Ltd. evaluates investment proposals at 10% cost of capital and its effective tax rate is 30%. Terminal payment in both cases is negligible and may be ignored.

Make calculations and show which quote is beneficial to P Ltd. Present value factors at 10% rate for years 1-4 are respectively 0.91, 0.83, 0.75 and 0.68. Calculations may be rounded off to 2 decimals in lakhs.

### Portfolio Management

11. Sunrise Limited last year paid dividend of ₹ 20 per share with an annual growth rate of 9%. The risk-free rate is 11% and the market rate of return is 15%. The company has a beta factor of 1.50. However, due to the decision of the Board of Director to grow inorganically in the recent past beta is likely to increase to 1.75.

You are required to find out under Capital Asset Pricing Model

- (i) The present value of the share
  - (ii) The likely value of the share after the decision.
12. A company has a choice of investments between several different equity oriented mutual funds. The company has an amount of ₹1 crore to invest. The details of the mutual funds are as follows:

| Mutual Fund | Beta |
|-------------|------|
| A           | 1.6  |
| B           | 1.0  |
| C           | 0.9  |
| D           | 2.0  |
| E           | 0.6  |

Required:

- (i) If the company invests 20% of its investment in the first two mutual funds and an equal amount in the mutual funds C, D and E, what is the beta of the portfolio?
- (ii) If the company invests 15% of its investment in C, 15% in A, 10% in E and the balance in equal amount in the other two mutual funds, what is the beta of the portfolio?
- (iii) If the expected return of market portfolio is 12% at a beta factor of 1.0, what will be the portfolios expected return in both the situations given above?

### Indian Capital Market

13. Derivative Bank entered into a plain vanilla swap through on OIS (Overnight Index Swap) on a principal of ₹ 10 crores and agreed to receive MIBOR overnight floating rate for a fixed payment on the principal. The swap was entered into on Monday, 2<sup>nd</sup> August, 2010 and was to commence on 3<sup>rd</sup> August, 2010 and run for a period of 7 days.

Respective MIBOR rates for Tuesday to Monday were:

7.75%, 8.15%, 8.12%, 7.95%, 7.98%, 8.15%.

If Derivative Bank received ₹ 317 net on settlement, calculate Fixed rate and interest under both legs.

Notes:

- (i) Sunday is Holiday.
- (ii) Work in rounded rupees and avoid decimal working.

14. The following market data is available:

Spot USD/JPY 116.00

| Deposit rates p.a. | USD   | JPY   |
|--------------------|-------|-------|
| 3 months           | 4.50% | 0.25% |
| 6 months           | 5.00% | 0.25% |

Forward Rate Agreement (FRA) for Yen is Nil.

- What should be 3 months FRA rate at 3 months forward?
- The 6 & 12 months LIBORS are 5% & 6.5% respectively. A bank is quoting 6/12 USD FRA at 6.50 – 6.75%. Is any arbitrage opportunity available?

Calculate profit in such case.

15. Given below is the Balance Sheet of S Ltd. as on 31.3.2008:

| Liabilities                      | ₹<br>(in lakh) | Assets              | ₹<br>(in lakh) |
|----------------------------------|----------------|---------------------|----------------|
| Share capital<br>(share of ₹ 10) | 100            | Land and building   | 40             |
| Reserves and surplus             | 40             | Plant and machinery | 80             |
| Long Term Debts                  | 30             | Investments         | 10             |
|                                  |                | Stock               | 20             |
|                                  |                | Debtors             | 15             |
|                                  |                | Cash at bank        | 5              |
|                                  | <u>170</u>     |                     | <u>170</u>     |

You are required to work out the value of the Company's, shares on the basis of Net Assets method and Profit-earning capacity (capitalization) method and arrive at the fair price of the shares, by considering the following information:

- (i) Profit for the current year ₹ 64 lakhs includes ₹ 4 lakhs extraordinary income and ₹ 1 lakh income from investments of surplus funds; such surplus funds are unlikely to recur.

- (ii) In subsequent years, additional advertisement expenses of ₹ 5 lakhs are expected to be incurred each year.
- (iii) Market value of Land and Building and Plant and Machinery have been ascertained at ₹ 96 lakhs and ₹ 100 lakhs respectively. This will entail additional depreciation of ₹ 6 lakhs each year.
- (iv) Effective Income-tax rate is 30%.
- (v) The capitalization rate applicable to similar businesses is 15%.
16. A company is long on 10 MT of copper @ ₹ 474 per kg (spot) and intends to remain so for the ensuing quarter. The standard deviation of changes of its spot and future prices are 4% and 6% respectively, having correlation coefficient of 0.75.
- What is its hedge ratio? What is the amount of the copper future it should short to achieve a perfect hedge?
17. Miss K holds 10,000 shares of IBS Bank @ 2,738.70 when 1 month Index Future was trading @ 6,086 The share has a Beta ( $\beta$ ) of 1.2. How many Index Futures should she short to perfectly hedge his position. A single Index Future is a lot of 50 indices.
- Justify your result in the following cases:
- (i) when the Index zooms by 1%
- (ii) when the Index plummets by 2%.

#### Capital Budgeting with Risk

18. Jumble Consultancy Group has determined relative utilities of cash flows of two forthcoming projects of its client company as follows :

| Cash Flow in ₹ | -15000 | -10000 | -4000 | 0 | 15000 | 10000 | 5000 | 1000 |
|----------------|--------|--------|-------|---|-------|-------|------|------|
| Utilities      | -100   | -60    | -3    | 0 | 40    | 30    | 20   | 10   |

The distribution of cash flows of project A and Project B are as follows:

|                  |         |         |       |       |       |
|------------------|---------|---------|-------|-------|-------|
| <b>Project A</b> |         |         |       |       |       |
| Cash Flow (₹)    | -15000  | - 10000 | 15000 | 10000 | 5000  |
| Probability      | 0.10    | 0.20    | 0.40  | 0.20  | 0.10  |
| <b>Project B</b> |         |         |       |       |       |
| Cash Flow (₹)    | - 10000 | -4000   | 15000 | 5000  | 10000 |
| Probability      | 0.10    | 0.15    | 0.40  | 0.25  | 0.10  |

Which project should be selected and why ?



**Dividend Decision**

19. X Ltd., has 8 lakhs equity shares outstanding at the beginning of the year. The current market price per share is ₹ 120. The Board of Directors of the company is contemplating ₹ 6.4 per share as dividend. The rate of capitalization, appropriate to the risk-class to which the company belongs, is 9.6%:
- Based on M-M Approach, calculate the market price of the share of the company, when the dividend is – (a) declared; and (b) not declared.
  - How many new shares are to be issued by the company, if the company desires to fund an investment budget of ₹ 3.20 crores by the end of the year assuming net income for the year will be ₹ 1.60 crores?
20. Write a short note on
- Lintner's Model of actual dividend behaviour
  - Necessary conditions to introduce 'Commodity Derivative'
  - 'Starting point and end point of an organisation is money'
  - Benefits of Real Estate Investment Trusts (REITs)
  - Chop Shop Method of Valuation

**SUGGESTED ANSWERS**

1.

| <i>Projected Balance Sheet</i> |        |        |        |        |
|--------------------------------|--------|--------|--------|--------|
|                                | Year 1 | Year 2 | Year 3 | Year 4 |
| Fixed Assets (40% of Sales)    | 9,600  | 11,520 | 13,824 | 13,824 |
| Current Assets (20% of Sales)  | 4,800  | 5,760  | 6,912  | 6,912  |
| Total Assets                   | 14,400 | 17,280 | 20,736 | 20,736 |
| Equity                         | 14,400 | 17,280 | 20,736 | 20,736 |

**Projected Cash Flows:**

|                   | Year 1 | Year 2 | Year 3   | Year 4   |
|-------------------|--------|--------|----------|----------|
| Sales             | 24,000 | 28,800 | 34,560   | 34,560   |
| PBT (10%) of sale | 2,400  | 2,880  | 3,456    | 3,456    |
| PAT (70%)         | 1,680  | 2,016  | 2,419.20 | 2,419.20 |
| Depreciation      | 800    | 960    | 1,152    | 1,382    |

|                            |       |       |            |          |
|----------------------------|-------|-------|------------|----------|
| Addition to Fixed Assets   | 2,400 | 2,880 | 3,456      | 1,382    |
| Increase in Current Assets | 800   | 960   | 1,152      | -        |
| Operating cash flow        | (720) | (864) | (1,036.80) | 2,419.20 |

**Projected Cash Flows:**

Present value of Projected Cash Flows:

| Cash Flows | PVF at 15% | PV             |
|------------|------------|----------------|
| -720       | 0.870      | -626.40        |
| -864       | 0.756      | -653.18        |
| -1,036.80  | 0.658      | <u>-682.21</u> |
|            |            | -1,961.79      |

Residual Value -  $2419.20/0.15 = 16,128$ 

$$\begin{aligned} \text{Present value of Residual value} &= 16128/(1.15)^3 \\ &= 16128/1.521 = 10603.55 \end{aligned}$$

$$\text{Total shareholders' value} = 10,603.55 - 1,961.79 = 8,641.76$$

$$\text{Pre strategy value} = 1,400 / 0.15 = 9,333.33$$

$$\therefore \text{Value of strategy} = 8,641.76 - 9,333.33 = -691.57$$

Conclusion: The strategy is not financially viable

**2.** The company can proceed in the following ways to realise arbitrage gain:

(a) Buy Rupees from US\$ at Mumbai: ₹ 64.10 x US\$ 2,00,00,000 = ₹ 128,20,00,000

(b) Convert Rupees from US\$ at London: ₹ 128,20,00,000/99.10 = GBP 1,29,36,427.85

(c) Convert GBP into US\$ at New York = GBP 1,29,36,427.85 x 1.5530 = US\$ 2,00,90,272.45

There is a Net Gain of = US\$ 2,00,90,272.45 - US\$ 2,00,00,000 = US\$ 90,272.45

**3.** On January 28, 2010 the importer customer requested to remit SGD 25 lakhs.

To consider sell rate for the bank:

$$\text{US \$} = ₹ 45.90$$

$$\text{Pound 1} = \text{US\$ } 1.7850$$

$$\text{Pound 1} = \text{SGD } 3.1575$$

$$\text{Therefore, SGD 1} = \frac{₹ 45.90 * 1.7850}{\text{SGD } 3.1575}$$

$$\text{SGD 1} = ₹ 25.9482$$

|                                   |   |                                               |
|-----------------------------------|---|-----------------------------------------------|
| Add: Exchange margin (0.125%)     | = | <u>₹ 0.0324</u>                               |
|                                   |   | <u>₹ 25.9806</u>                              |
| On February 4, 2010 the rates are |   |                                               |
| US \$                             | = | ₹ 45.97                                       |
| Pound 1                           | = | US\$ 1.7775                                   |
| Pound 1                           | = | SGD 3.1380                                    |
| Therefore, SGD 1                  | = | $\frac{₹ 45.97 * 1.7775}{\text{SGD } 3.1380}$ |
| SGD 1                             | = | ₹ 26.0394                                     |
| Add: Exchange margin (0.125%)     |   | <u>₹ 0.0325</u>                               |
|                                   |   | <u>₹ 26.0719</u>                              |

Hence, loss to the importer

$$= \text{SGD } 25,00,000 (\text{₹}26.0719 - \text{₹}25.9806) = \text{₹ } 2,28,250$$

4. In order to find out the NAV, the cash balance at the end of the year is calculated as follows-

| Particulars                                                 | ₹                  |
|-------------------------------------------------------------|--------------------|
| Cash balance in the beginning<br>(₹ 100 lakhs – ₹ 98 lakhs) | 2,00,000           |
| Dividend Received                                           | 12,00,000          |
| Interest on 7% Govt. Securities                             | 56,000             |
| Interest on 9% Debentures                                   | 45,000             |
| Interest on 10% Debentures                                  | <u>50,000</u>      |
|                                                             | 15,51,000          |
| (-) Operating expenses                                      | <u>5,00,000</u>    |
| Net cash balance at the end                                 | <u>10,51,000</u>   |
| <b>Calculation of NAV</b>                                   | ₹                  |
| Cash Balance                                                | 10,51,000          |
| 7% Govt. Securities (at par)                                | 8,00,000           |
| 50,000 equity shares @ ₹ 175 each                           | 87,50,000          |
| 9% Debentures (Unlisted) at cost                            | 5,00,000           |
| 10% Debentures @90%                                         | <u>4,50,000</u>    |
| Total Assets                                                | <u>1,15,51,000</u> |

|              |           |
|--------------|-----------|
| No. of Units | 10,00,000 |
| NAV per Unit | ₹ 11.55   |

Calculation of NAV, if dividend of ₹ 0.80 is paid –

|                                         |               |
|-----------------------------------------|---------------|
| Net Assets (₹ 1,15,51,000 – ₹ 8,00,000) | ₹ 1,07,51,000 |
| No. of Units                            | 10,00,000     |
| NAV per unit                            | ₹ 10.75       |

5. Computation of current value of G's portfolio

(i) 100 Nos. Bond A, ₹ 1,000 par value, 9% Bonds maturity 3 years:

|                                                             |               |
|-------------------------------------------------------------|---------------|
|                                                             | ₹             |
| Current value of interest on bond A                         |               |
| 1-3 years: ₹ 9000 × Cumulative P.V. @ 12% (1-3 years)       | 21,618        |
| = ₹ 9000 × 2.402                                            |               |
| Add: Current value of amount received on maturity of Bond A |               |
| End of 3rd year: ₹ 1,000 × 100 × P.V. @ 12% (3rd year)      | 71,200        |
| = ₹ 1,00,000 × 0.712                                        |               |
|                                                             | <u>92,818</u> |

(ii) 100 Nos. Bond B, ₹ 1,000 par value, 10% Bonds maturity 5 years:

|                                                             |               |
|-------------------------------------------------------------|---------------|
| Current value of interest on bond B                         |               |
| 1-5 years: ₹ 10,000 × Cumulative P.V. @ 12% (1-5 years)     |               |
| = ₹ 10,000 × 3.605                                          | 36,050        |
| Add: Current value of amount received on maturity of Bond B |               |
| End of 5th year: ₹ 1,000 × 100 × P.V. @ 12% (5th year)      | 56,700        |
| = ₹ 1,00,000 × 0.567                                        | <u>92,750</u> |

(iii) 100 Preference shares C, ₹ 1,000 par value, 11% coupon

$$\frac{11\% \times 1000 \text{ Nos.} \times ₹ 100}{13\%} = \frac{11,000}{0.13} = 84,615$$

(iv) 100 Preference shares D, ₹ 1,000 par value, 12% coupon

$$\frac{12\% \times 1000 \text{ Nos.} \times ₹ 100}{13\%} = \frac{12,000}{0.13} = 92,308$$

Total current value of his portfolio [(i) + (ii) + (iii) + (iv)] 3,62,491

## 6. (a) Calculation of Profit after tax (PAT)

|                                                 | ₹               |
|-------------------------------------------------|-----------------|
| Profit before interest and tax (PBIT)           | 32,00,000       |
| Less: Debenture interest (₹ 64,00,000 × 12/100) | <u>7,68,000</u> |
| Profit before tax (PBT)                         | 24,32,000       |
| Less: Tax @ 35%                                 | <u>8,51,200</u> |
| Profit after tax (PAT)                          | 15,80,800       |
| Less: Preference Dividend                       |                 |
| (₹ 40,00,000 × 8/100)                           | 3,20,000        |
| Equity Dividend (₹ 80,00,000 × 8/100)           | <u>6,40,000</u> |
| Retained earnings (Undistributed profit)        | <u>6,20,800</u> |

## Calculation of Interest and Fixed Dividend Coverage

$$= \frac{\text{PAT} + \text{Debenture interest}}{\text{Debenture interest} + \text{Preference dividend}}$$

$$= \frac{15,80,800 + 7,68,000}{7,68,000 + 3,20,000} = \frac{23,48,800}{10,88,000} = 2.16 \text{ times}$$

## (b) Calculation of Capital Gearing Ratio

$$\text{Capital Gearing Ratio} = \frac{\text{Fixed interest bearing funds}}{\text{Equity shareholders' funds}}$$

$$= \frac{\text{Preference Share Capital} + \text{Debentures}}{\text{Equity Share Capital} + \text{Reserves}} = \frac{40,00,000 + 64,00,000}{80,00,000 + 32,00,000}$$

$$= \frac{1,04,00,000}{1,12,00,000} = 0.93$$

## (c) Calculation of Yield on Equity Shares:

Yield on equity shares is calculated at 50% of profits distributed and 5% on undistributed profits: (₹)

|                                                  |                 |
|--------------------------------------------------|-----------------|
| 50% on distributed profits (₹ 6,40,000 × 50/100) | 3,20,000        |
| 5% on undistributed profits (₹ 6,20,800 × 5/100) | <u>31,040</u>   |
| Yield on equity shares                           | <u>3,51,040</u> |

$$\begin{aligned}\text{Yield on equity shares \%} &= \frac{\text{Yield on shares}}{\text{Equity share capital}} \times 100 \\ &= \frac{3,51,040}{80,00,000} \times 100 = 4.39\% \text{ or, } 4.388\%.\end{aligned}$$

**Calculation of Expected Yield on Equity shares**

**Note:** There is a scope for assumptions regarding the rates (in terms of percentage for every one time of difference between Sun Ltd. and Industry Average) of risk premium involved with respect to Interest and Fixed Dividend Coverage and Capital Gearing Ratio. The below solution has been worked out by assuming the risk premium as:

- (i) 1% for every one time of difference for Interest and Fixed Dividend Coverage.
- (ii) 2% for every one time of difference for Capital Gearing Ratio.
  - (a) Interest and fixed dividend coverage of Sun Ltd. is 2.16 times but the industry average is 3 times. Therefore, risk premium is added to Sun Ltd. Shares @ 1% for every 1 time of difference.  
 $\text{Risk Premium} = 3.00 - 2.16 (1\%) = 0.84 (1\%) = 0.84\%$
  - (b) Capital Gearing ratio of Sun Ltd. is 0.93 but the industry average is 0.75 times. Therefore, risk premium is added to Sun Ltd. shares @ 2% for every 1 time of difference.

$$\begin{aligned}\text{Risk Premium} &= (0.75 - 0.93) (2\%) \\ &= 0.18 (2\%) = 0.36\%\end{aligned}$$

|                                                                |              |
|----------------------------------------------------------------|--------------|
|                                                                | (%)          |
| Normal return expected                                         | 9.60         |
| Add: Risk premium for low interest and fixed dividend coverage | 0.84         |
| Add: Risk premium for high interest gearing ratio              | <u>0.36</u>  |
|                                                                | <u>10.80</u> |

**Value of Equity Share**

$$= \frac{\text{Actual yield}}{\text{Expected yield}} \times \text{Paid-up value of share} = \frac{4.39}{10.80} \times 100 = ₹ 40.65$$

7. (i) Straight Value of Bond  
 $= ₹ 85 \times 0.9132 + ₹ 85 \times 0.8340 + ₹ 1085 \times 0.7617 = ₹ 974.96$
- (ii) Conversion Value  
 $= \text{Conversion Ration} \times \text{Market Price of Equity Share}$   
 $= ₹ 45 \times 25 = ₹ 1,125$

## (iii) Conversion Premium

Conversion Premium = Market Conversion Price - Market Price of Equity Share

$$= \frac{\text{₹ } 1,175}{25} - \text{₹ } 45 = \text{₹ } 2$$

## (iv) Percentage of Downside Risk

$$= \frac{\text{₹ } 1,175 - \text{₹ } 974.96}{\text{₹ } 974.96} \times 100 = 20.52\%$$

## (v) Conversion Parity Price

$$= \frac{\text{Bond Price}}{\text{No. of Share on Conversion}} = \frac{\text{₹ } 1,175}{25} = \text{₹ } 47$$

8.

| Date | 1<br>Sensex | 2<br>EMA for<br>Previous day | 3<br>1-2 | 4<br>3×0.062 | 5<br>EMA<br>2 ± 4 |
|------|-------------|------------------------------|----------|--------------|-------------------|
| 6    | 14522       | 15000                        | (478)    | (29.636)     | 14970.364         |
| 7    | 14925       | 14970.364                    | (45.364) | (2.812)      | 14967.55          |
| 10   | 15222       | 14967.55                     | 254.45   | 15.776       | 14983.32          |
| 11   | 16000       | 14983.32                     | 1016.68  | 63.034       | 15046.354         |
| 12   | 16400       | 15046.354                    | 1353.646 | 83.926       | 15130.28          |
| 13   | 17000       | 15130.28                     | 1869.72  | 115.922      | 15246.202         |
| 17   | 18000       | 15246.202                    | 2753.798 | 170.735      | 15416.937         |

**Conclusion** – The market is bullish. The market is likely to remain bullish for short term to medium term if other factors remain the same. On the basis of this indicator (EMA) the investors/brokers can take long position.

## 9. Financial Analysis whether to set up the manufacturing units in India or not may be carried using NPV technique as follows:

## I. Incremental Cash Outflows

|                                     | \$ Million |
|-------------------------------------|------------|
| Cost of Plant and Machinery         | 500.00     |
| Working Capital                     | 50.00      |
| Release of existing Working Capital | (15.00)    |
|                                     | 535.00     |

## II. Incremental Cash Inflow after Tax (CFAT)

## (a) Generated by investment in India for 5 years

|                                                                  | \$ Million |
|------------------------------------------------------------------|------------|
| Sales Revenue (5 Million x \$80)                                 | 400.00     |
| Less: Costs                                                      |            |
| Variable Cost (5 Million x \$20)                                 | 100.00     |
| Fixed Cost                                                       | 30.00      |
| Depreciation (\$500Million/5)                                    | 100.00     |
| EBIT                                                             | 170.00     |
| Taxes@35%                                                        | 59.50      |
| EAT                                                              | 110.50     |
| Add: Depreciation                                                | 100.00     |
| CFAT (1-5 years)                                                 | 210.50     |
| Cash flow at the end of the 5 years (Release of Working Capital) | 35.00      |

## (b) Cash generation by exports

|                                          | \$ Million |
|------------------------------------------|------------|
| Sales Revenue (1.5 Million x \$80)       | 120.00     |
| Less: Variable Cost (1.5 Million x \$40) | 60.00      |
| Contribution before tax                  | 60.00      |
| Tax@35%                                  | 21.00      |
| CFAT (1-5 years)                         | 39.00      |

## (c) Additional CFAT attributable to Foreign Investment

|                                        | \$ Million |
|----------------------------------------|------------|
| Through setting up subsidiary in India | 210.50     |
| Through Exports in India               | 39.00      |
| CFAT (1-5 years)                       | 171.50     |

## III. Determination of NPV

| Year | CFAT (\$ Million) | PVF@12% | PV(\$ Million) |
|------|-------------------|---------|----------------|
| 1-5  | 171.50            | 3.6048  | 618.2232       |
| 5    | 35                | 0.5674  | 19.8590        |



|                       |          |
|-----------------------|----------|
|                       | 638.0822 |
| Less: Initial Outflow | 535.0000 |
|                       | 103.0822 |

Since NPV is positive the proposal should be accepted.

10.

(in lakhs)

|                                                            | Quote A       | Quote B       |
|------------------------------------------------------------|---------------|---------------|
| <b>Calculation of Present Value (PV) of cash payments:</b> |               |               |
| Initial lease rent (PV)                                    | 5.00          | 1.00          |
| Less: PV of tax benefit on initial payment of lease rent   |               |               |
| ₹ 5.00 lakh x 0.30 x 0.91                                  | (1.365)       | -             |
| ₹ 1.00 lakh x 0.30 x 0.91                                  | -             | (0.273)       |
| PV of Annual lease rents                                   |               |               |
| ₹ 21.06 lakh x 0.7 x 2.49                                  | 36.71         | -             |
| ₹ 19.66 lakh x 0.7 x 3.17                                  | -             | 43.63         |
| <b>Total payments in PV</b>                                | <b>40.345</b> | <b>44.357</b> |
| Capital Recovery Factor (reciprocal of Annuity Factor)     |               |               |
| 1/2.49                                                     | 0.402         | -             |
| 1/3.17                                                     | -             | 0.315         |
| <b>Equated Annual Payment or cash outflow (₹ lakhs)</b>    | <b>16.20</b>  | <b>13.979</b> |

**Conclusion:** Since Quote B implies lesser equated annual cash outflow, it is better.

11. The value of Cost of Equity with the help of CAPM

$$K_e = R_f + \beta(R_m - R_f)$$

With the given data the Cost of Equity using CAPM will be:

$$K_e = 0.11 + 1.5(0.15 - 0.11)$$

$$K_e = 0.11 + 1.5(0.04) = 0.17 \text{ or } 17\%$$

The value of share using the Growth Model:

$$P = \frac{D_0(1+g)}{k_e - g}$$

$$P = \frac{20(1+0.09)}{0.17 - 0.09}$$

$$P = \frac{21.80}{0.08} = ₹ 272.50$$

However, if the decision of the Board of Directors is implemented, the beta factor is likely to increase to 1.75.

Therefore,

$$K_e = 0.11 + 1.75(0.15 - 0.11)$$

$$K_e = 0.11 + 1.75(0.04) = 0.18 \text{ or } 18\%$$

The value of share using the Growth Model:

$$P = \frac{D_0(1+g)}{k_e - g}$$

$$P = \frac{20(1+0.09)}{0.18 - 0.09}$$

$$P = \frac{21.80}{0.09} = ₹ 242.22$$

12. With 20% investment in each MF Portfolio Beta is the weighted average of the Betas of various securities calculated as below:

(i)

| Investment                       | Beta ( $\beta$ ) | Investment<br>(₹ Lacs) | Weighted<br>Investment |
|----------------------------------|------------------|------------------------|------------------------|
| A                                | 1.6              | 20                     | 32                     |
| B                                | 1.0              | 20                     | 20                     |
| C                                | 0.9              | 20                     | 18                     |
| D                                | 2.0              | 20                     | 40                     |
| E                                | 0.6              | <u>20</u>              | <u>12</u>              |
|                                  |                  | <u>100</u>             | <u>122</u>             |
| Weighted Beta ( $\beta$ ) = 1.22 |                  |                        |                        |

- (ii) With varied percentages of investments portfolio beta is calculated as follows:

| Investment | Beta ( $\beta$ ) | Investment<br>(₹ Lacs) | Weighted<br>Investment |
|------------|------------------|------------------------|------------------------|
| A          | 1.6              | 15                     | 24                     |
| B          | 1.0              | 30                     | 30                     |
| C          | 0.9              | 15                     | 13.5                   |
| D          | 2.0              | 30                     | 60                     |

|                                   |     |            |              |
|-----------------------------------|-----|------------|--------------|
| E                                 | 0.6 | <u>10</u>  | <u>6</u>     |
|                                   |     | <u>100</u> | <u>133.5</u> |
| Weighted Beta ( $\beta$ ) = 1.335 |     |            |              |

- (iii) Expected return of the portfolio with pattern of investment as in case (i) =  $12\% \times 1.22$   
i.e. 14.64%

Expected Return with pattern of investment as in case (ii) =  $12\% \times 1.335$  i.e., 16.02%.

13.

| Day                         | Principal (₹) | MIBOR (%) | Interest (₹)    |
|-----------------------------|---------------|-----------|-----------------|
| Tuesday                     | 10,00,00,000  | 7.75      | 21,233          |
| Wednesday                   | 10,00,21,233  | 8.15      | 22,334          |
| Thursday                    | 10,00,43,567  | 8.12      | 22,256          |
| Friday                      | 10,00,65,823  | 7.95      | 21,795          |
| Saturday & Sunday (*)       | 10,00,87,618  | 7.98      | 43,764          |
| Monday                      | 10,01,31,382  | 8.15      | <u>22,358</u>   |
| Total Interest @ Floating   |               |           | 1,53,740        |
| Less: Net Received          |               |           | <u>317</u>      |
| Expected Interest @ fixed   |               |           | <u>1,53,423</u> |
| Thus Fixed Rate of Interest |               |           | 0.07999914      |
| Approx.                     |               |           | 8%              |

(\*) i.e. interest for two days.

**Note:** Alternatively, answer can also be calculated on the basis of 360 days in a year.

14. 1. **3 Months Interest rate is 4.50% & 6 Months Interest rate is 5% p.a.**

Future Value 6 Months from now is a product of Future Value 3 Months now & 3 Months

Future Value from after 3 Months.

$$(1+0.05*6/12) = (1+0.045*3/12) \times (1+i_{3,6} * 3/12)$$

$$i_{3,6} = [(1+0.05*6/12) / (1+0.045*3/12) - 1] * 12/3$$

i.e. 5.44% p.a.

2. **6 Months Interest rate is 5% p.a. & 12 Month interest rate is 6.5% p.a.**

Future value 12 month from now is a product of Future value 6 Months from now and 6

Months Future value from after 6 Months.

$$(1+0.065) = (1+0.05*6/12) \times (1+i_{6,6} *6/12)$$

$$i_{6,6} = [(1+0.065/1.025) - 1] *12/6$$

6 Months forward 6 month rate is 7.80% p.a.

The Bank is quoting 6/12 USD FRA at 6.50 – 6.75%

Therefore there is an arbitrage Opportunity of earning interest @ 7.80% p.a. & Paying @ 6.75%

**Borrow for 6 months, buy an FRA & invest for 12 months**

To get \$ 1.065 at the end of 12 months for \$ 1 invested today

To pay \$ 1.060# at the end of 12 months for every \$ 1 Borrowed today

Net gain \$ 0.005 i.e. risk less profit for every \$ borrowed

$$\# (1+0.05/2) (1+.0675/2) = (1.05959) \text{ say } 1.060$$

15.

|                          | ₹ lakhs    |
|--------------------------|------------|
| <b>Net Assets Method</b> |            |
| Assets: Land & Buildings | 96         |
| Plant & Machinery        | 100        |
| Investments              | 10         |
| Stocks                   | 20         |
| Debtors                  | 15         |
| Cash & Bank              | <u>5</u>   |
| Total Assets             | 246        |
| Less: Long Term Debts    | <u>30</u>  |
| Net Assets               | <u>216</u> |

**Value per share**

(a) Number of shares  $\frac{1,00,00,000}{10} = 10,00,000$

(b) Net Assets ₹ 2,16,00,000

$$\frac{₹ 2,16,00,000}{10,00,000} = ₹ 21.6$$

| Profit-earning Capacity Method                 |             | ₹ lakhs      |
|------------------------------------------------|-------------|--------------|
| Profit before tax                              |             | 64.00        |
| Less: Extraordinary income                     | 4.00        |              |
| Investment income (not likely to recur)        | <u>1.00</u> | <u>5.00</u>  |
|                                                |             | 59.00        |
| Less: Additional expenses in forthcoming years |             |              |
| Advertisement                                  | 5.00        |              |
| Depreciation                                   | <u>6.00</u> | <u>11.00</u> |
| Expected earnings before taxes                 |             | 48.00        |
| Less: Income-tax @ 30%                         |             | <u>14.40</u> |
| Future maintainable profits (after taxes)      |             | <u>33.60</u> |

Value of business

|                       |                        |     |
|-----------------------|------------------------|-----|
| Capitalisation factor | $\frac{33.60}{0.15} =$ | 224 |
|-----------------------|------------------------|-----|

|                       |  |            |
|-----------------------|--|------------|
| Less: Long Term Debts |  | <u>30</u>  |
|                       |  | <u>194</u> |

|                 |                                 |         |
|-----------------|---------------------------------|---------|
| Value per share | $\frac{1,94,00,000}{10,00,000}$ | ₹ 19.40 |
|-----------------|---------------------------------|---------|

| Fair Price of share                                          | ₹      |
|--------------------------------------------------------------|--------|
| Value as per Net Assets Method                               | 21.60  |
| Value as per Profit earning capacity (Capitalisation) method | 19.40  |
| Fair Price= $\frac{21.60 + 19.40}{2} = \frac{41.00}{2} =$    | ₹20.50 |

16. The optional hedge ratio to minimize the variance of Hedger's position is given by:

$$H = \rho \frac{\sigma_S}{\sigma_F}$$

Where

$\sigma_S$  = Standard deviation of  $\Delta S$

$\sigma_F$  = Standard deviation of  $\Delta F$

$\rho$  = coefficient of correlation between  $\Delta S$  and  $\Delta F$

H = Hedge Ratio

$\Delta S$  = change in Spot price.

$\Delta F$  = change in Future price.

Accordingly

$$H = 0.75 \times \frac{0.04}{0.06} = 0.5$$

No. of contract to be short =  $10 \times 0.5 = 5$

Amount =  $5000 \times ₹ 474 = ₹ 23,70,000$

17. Value of Portfolio of Miss. K (₹ 2,738.70X10,000) ₹ 2,73,87,000

Number of index future to be sold by Miss. K is:  $\frac{1.2 \times 2738.70 \times 10000}{6,086 \times 50} = 108 \text{ contract}$

- (i) Justification of the answer if index is zoomed by 1%:

Gain in the value of the portfolio ₹ 2,73,87,000X1%X1.2 ₹ 3,28,644

Loss by short covering of index future is  $0.01 \times 6,086 \times 50 \times 108$  ₹ 3,28,644

This justifies the result.

- (ii) Justification of the answer if index is plummets by 2%:

Loss in the value of the portfolio ₹ 2,73,87,000X2%X1.2 ₹ 6,57,288

Gain by short covering of index future is  $0.02 \times 6,086 \times 50 \times 108$  ₹ 6,57,288

This justifies the result.

18. Evaluation of project utilizes of Project A and Project B

| Project A           |             |         |               |
|---------------------|-------------|---------|---------------|
| Cash flow<br>(in ₹) | Probability | Utility | Utility value |
| -15,000             | 0.10        | -100    | -10           |
| - 10,000            | 0.20        | -60     | -12           |
| 15,000              | 0.40        | 40      | 16            |
| 10,000              | 0.20        | 30      | 6             |
| 5,000               | 0.10        | 20      | <u>2</u>      |
|                     |             |         | <u>2</u>      |

| Project B           |             |         |               |
|---------------------|-------------|---------|---------------|
| Cash flow<br>(in ₹) | Probability | Utility | Utility value |
| -10,000             | 0.10        | -60     | -6            |

|        |      |    |              |
|--------|------|----|--------------|
| -4,000 | 0.15 | -3 | -0.45        |
| 15,000 | 0.40 | 40 | 16           |
| 5,000  | 0.25 | 20 | 5            |
| 10,000 | 0.10 | 30 | <u>3</u>     |
|        |      |    | <u>17.55</u> |

Project B should be selected as its expected utility is more

**19. Modigliani and Miller (M-M) – Dividend Irrelevancy Model:**

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

Where,

$P_0$  = Existing market price per share i.e. ₹ 120

$P_1$  = Market price of share at the year-end (to be determined)

$D_1$  = Contemplated dividend per share i.e. ₹ 6.4

$K_e$  = Capitalisation rate i.e. 9.6%.

**(i) (a) Calculation of share price when dividend is declared:**

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$120 = \frac{P_1 + 6.4}{1 + 0.096}$$

$$120 \times 1.096 = P_1 + 6.4$$

$$P_1 = 120 \times 1.096 - 6.4$$

$$= 125.12$$

**(b) Calculation of share price when dividend is not declared:**

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

$$120 = \frac{P_1 + 0}{1 + 0.096}$$

$$120 \times 1.096 = P_1 + 0$$

$$P_1 = 131.52$$

## (ii) Calculation of No. of shares to be issued:

(₹ in lakhs)

| Particulars                                    | If dividend declared | If dividend not declared |
|------------------------------------------------|----------------------|--------------------------|
| Net Income                                     | 160                  | 160                      |
| Less: Dividend paid                            | <u>51.20</u>         | <u>-----</u>             |
| Retained earnings                              | 108.80               | 160                      |
| Investment budget                              | <u>320</u>           | <u>320</u>               |
| Amount to be raised by issue of new shares (i) | <u>211.20</u>        | <u>160</u>               |
| Market price per share (ii)                    | 125.12               | 131.52                   |
| No. of new shares to be issued (ii)            | 1,68,797.95          | 1,21,654.50              |
| Or say                                         | 1,68,798             | 1,21,655                 |

20. (a) The classic study of the actual dividend behavior was done by John Lintner in 1956. The study was conducted in two stages. First, he conducted a series of interviews with businessmen to form a view of how they went about their dividends decisions. He then formed a model on the basis of those interviews which could be tested on a larger data. His formula is

$$D_1 = D_0 + [(EPS \times \text{Target Payout}) - D_0] \times A_F$$

Where

$D_1$  = Dividend in year 1

$D_0$  = Dividend in year 0

EPS = Earning Per Share

$A_F$  = Adjustment Factor

Lintner model has two parameters:

- (1) The target pay-out ratio and
- (2) The spread at which current dividends adjust to the target.

From the interviews he conducted, it emerged that investment needs were not a major consideration in the determination of dividend policy, rather the decision to change the dividend was usually a response to a significant change in earnings which had disturbed the existing relationship between earnings and dividends. Lintner concluded that

- (1) Companies tend to set long run target dividends-to-earning ratios according to the amount of positive net present value (NPV) project that are available.



- (2) Earning increases are not always sustainable. As a result, dividend policy is not changed until managers can see that new earnings level are sustainable.
- (b) The following attributes are considered crucial for qualifying for the derivatives trade:
  - (1) a commodity should be durable and it should be possible to store it;
  - (2) units must be homogeneous;
  - (3) the commodity must be subject to frequent price fluctuations with wide amplitude; supply and demand must be large;
  - (4) supply must flow naturally to market and there must be breakdowns in an existing pattern of forward contracting.

The first attribute, durability and storability, has received considerable attention in commodity finance, since one of the economic functions often attributed to commodity derivatives markets is the temporal allocation of stocks.

Since commodity derivatives contracts are standardized contracts, the second attribute, requires the underlying product to be homogeneous, so that the underlying commodity as defined in the commodity derivatives contract corresponds with the commodity traded in the cash market. This allows for actual delivery in the commodity derivatives market.

The third attribute, a fluctuating price, is of great importance, since firms will feel little incentive to insure themselves against price risk if price changes are small. A broad cash market is important because a large supply of the commodity will make it difficult to establish dominance in the market place and a broad cash market will tend to provide for a continuous and orderly meeting of supply and demand forces.

The last crucial attribute, breakdowns in an existing pattern of forward trading, indicates that cash market risk will have to be present for a commodity derivatives market to come into existence. Should all parties decide to eliminate each and every price fluctuation by using cash forward contracts for example, a commodity derivatives market would be of little interest.

- (c) No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital.

Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio. However this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. Investment proposals mooted by different business units may be addition of a new product, increasing the level of operation of an existing product and cost reduction and efficient utilization of resources through a new approach and closer monitoring of the different critical activities.

Now, given these three types of proposals a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and future stake holders of the company. As a result, preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

(d) Reits typically offer the following benefits:

- For the Investors: REITs as an investment class provide the common man an opportunity to invest in fixed income securities which also provide long term capital appreciation and a natural inflation hedge. It also opens to small investors an arena (i.e. rent generating real estate assets) which was hitherto the monopoly of large investors.
- For the Industry: Reits assist in streamlining the real estate sector by creating a new and transparent source of raising finance in the real estate sector. Further, Reits can provide developers with institutional capital to sell their assets and use funds to repay banks and/or utilize the funds for more

development.

- (e) This approach attempts to identify multi-industry companies that are undervalued and would have more value if separated from each other. In other words as per this approach an attempt is made to buy assets below their replacement value. This approach involves following three steps:

**Step 1:** Identify the firm's various business segments and calculate the average capitalization ratios for firms in those industries.

**Step 2:** Calculate a "theoretical" market value based upon each of the average capitalization ratios.

**Step 3:** Average the "theoretical" market values to determine the "chop-shop" value of the firm.