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PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

Question No.1 is compulsory.

Answer any **five** questions from the remaining six questions.

Working notes should form part of the answer.

Question 1

- (a) Edelweiss Bank Ltd. sold Hong Kong dollar 2 crores value spot to its customer at ₹ 8.025 and covered itself in the London market on the same day, when the exchange rates were

US\$ 1 =HK \$ 7.5880-7.5920

Local interbank market rates for US \$ were

Spot US \$ 1 – ₹60.70-61.00

Calculate the cover rate and ascertain the profit or loss on the transaction. Ignore brokerage. (5 Marks)

- (b) Wonderland Limited has excess cash of ₹ 20 lakhs, which it wants to invest in short term marketable securities. Expenses relating to investment will be ₹ 50,000.

The securities invested will have an annual yield of 9%.

The company seeks your advice

(i) as to the period of investment so as to earn a pre-tax income of 5%.

(ii) the minimum period for the company to break even its investment expenditure over time value of money. (5 Marks)

- (c) Elrond Limited plans to acquire Doom Limited. The relevant financial details of the two firms prior to the merger announcement are:

	Elrond Limited	Doom Limited
Market price per share	₹ 50	₹ 25
Number of outstanding shares	20 lakhs	10 Lakhs

The merger is expected to generate gains, which have a present value of ₹ 200 lakhs. The exchange ratio agreed to is 0.5.

What is the true cost of the merger from the point of view of Elrond Limited?

(5 Marks)

- (d) Goldilocks Ltd. was started a year back with equity capital of ₹ 40 lakhs. The other details are as under:

Earnings of the company	₹ 4,00,000
Price Earnings ratio	12.5
Dividend paid	₹ 3,20,000
Number of Shares	40,000

Find the current market price of the share. Use Walter's Model.

Find whether the company's D/ P ratio is optimal, use Walter's formula. (5 Marks)

Answer

- (a) The bank (Dealer) covers itself by buying from the market at market selling rate.

Rupee – Dollar selling rate	= ₹61.00
Dollar – Hong Kong Dollar	= HK \$ 7.5880
Rupee – Hong Kong cross rate	= ₹61.00 / 7.5880
	= ₹8.039

Profit / Loss to the Bank

Amount received from customer (2 crore × 8.025)	₹16,05,00,000
Amount paid on cover deal (2 crore × 8.039)	<u>₹16,07,80,000</u>
Loss to Bank	<u>₹ 2,80,000</u>

- (b) (i) Pre-tax Income required on investment of ₹20,00,000

Let the period of Investment be 'P' and return required on investment ₹1,00,000
(₹20,00,000 × 5%)

Accordingly,

$$(\text{₹}20,00,000 \times \frac{9}{100} \times \frac{P}{12}) - \text{₹}50,000 = \text{₹}1,00,000$$

$$P = 10 \text{ months}$$

- (ii) Break-Even its investment expenditure

$$(\text{₹}20,00,000 \times \frac{9}{100} \times \frac{P}{12}) - \text{₹}50,000 = 0$$

$$P = 3.33 \text{ months}$$

- (c) Shareholders of Doom Ltd. will get 5 lakh share of Elrond Limited, so they will get:

$$= \frac{5 \text{ lakh}}{20 \text{ lakh} + 5 \text{ lakh}} = 20\% \text{ of shares Elrond Limited}$$

The value of Elrond Ltd. after merger will be:

$= ₹50 \times 20 \text{ lakh} + ₹25 \times 10 \text{ lakh} + ₹200 \text{ lakh}$
 $= ₹1000 \text{ lakh} + ₹250 \text{ lakh} + ₹200 \text{ lakh} = ₹1450 \text{ lakh}$
 True Cost of Merger will be:
 $(₹1450 \times 20\%) ₹290 \text{ lakhs} - ₹250 \text{ lakhs} = ₹40 \text{ lakhs}$

(d) Goldilocks Ltd.

(i) Walter's model is given by

$$P = \frac{D + (E - D)(r / K_e)}{K_e}$$

Where,

P = Market price per share.
 E = Earnings per share = ₹10
 D = Dividend per share = ₹8
 r = Return earned on investment = 10%
 K_e = Cost of equity capital = $1/12.5 = 8\%$

$$\begin{aligned}
 P &= \frac{8 + (10 - 8) \times \frac{0.10}{0.08}}{0.08} = \frac{8 + 2 \times \frac{0.10}{0.08}}{0.08} \\
 &= ₹131.25
 \end{aligned}$$

(ii) According to Walter's model when the return on investment is more than the cost of equity capital, the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is nil.

So, at a pay-out ratio of zero, the market value of the company's share will be:

$$\frac{0 + (10 - 0) \frac{0.10}{0.08}}{0.08} = ₹156.25$$

Question 2

(a) The valuation of Hansel Limited has been done by an investment analyst. Based on an expected free cash flow of ₹ 54 lakhs for the following year and an expected growth rate of 9 percent, the analyst has estimated the value of Hansel Limited to be ₹ 1800 lakhs. However, he committed a mistake of using the book values of debt and equity.

The book value weights employed by the analyst are not known, but you know that Hansel Limited has a cost of equity of 20 percent and post tax cost of debt of 10 percent.

The value of equity is thrice its book value, whereas the market value of its debt is nine-tenths of its book value. What is the correct value of Hansel Ltd? (6 Marks)

- (b) Gretel Limited is setting up a project for manufacture of boats at a cost of ₹ 300 lakhs. It has to decide whether to locate the plant in next to the sea shore (Area A) or in a inland area with no access to any waterway (Area B). If the project is located in Area B then Gretel Limited receives a cash subsidy of ₹ 20 lakhs from the Central Government. Besides, the taxable profits to the extent of 20% is exempt for 10 years in Area B. The project envisages a borrowing of ₹ 200 lakhs in either case. The rate of Interest per annum is 12% in Area A and 10% in Area B.

The borrowing of principal has to be repaid in 4 equal installments beginning from the end of the 4th year.

With the help of the following information, you are required to suggest the proper location for the project to the CEO of Gretel Limited. Assume straight line depreciation with no residual value, income tax 50% and required rate of return 15%.

Year	Earnings before Depreciation, Interest and Tax (EBDIT) (₹ In lakhs)	
	Area A	Area B
1	(6)	(50)
2	34	(50)
3	54	10
4	74	20
5	108	45
6	142	100
7	156	155
8	230	190
9	330	230
10	430	330

The PVIF @ 15% for 10 years are as below:

Year	1	2	3	4	5	6	7	8	9	10
PVIF	0.87	0.76	0.66	0.57	0.50	0.43	0.38	0.33	0.28	0.25

(10 Marks)

Answer

- (a) Cost of capital by applying Free Cash Flow to Firm (FCFF) Model is as follows:-

$$\text{Value of Firm} = V_0 = \frac{\text{FCFF}_1}{K_c - g_n}$$

Where –

FCFF_1 = Expected FCFF in the year 1

K_c = Cost of capital

g_n = Growth rate forever

Thus, ₹1800 lakhs = ₹54 lakhs / ($K_c - g$)

Since $g = 9\%$, then $K_c = 12\%$

Now, let X be the weight of debt and given cost of equity = 20% and cost of debt = 10%, then $20\% (1 - X) + 10\% X = 12\%$

Hence, $X = 0.80$, so book value weight for debt was 80%

∴ Correct weight should be 60 of equity and 40 of debt.

∴ Cost of capital = $K_c = 20\% (60/132) + 10\% (72/132) = 14.5455\%$

and correct firm's value = ₹ 54 lakhs / (0.1454 – 0.09) = ₹ 974.73 lakhs.

- (b) On next page.

Statement Showing the Net Present Values of the Project at 15%

Area A :

(₹ in lakhs)

Year	Profit (Loss) Before Interest & Depreciation	Depre-* ciation	Interest	PBT	Income Tax @ 50%	Profit After Tax	Cash Inflows	Cash outflows	Net Cash Flow	Present Value Factor (at 15%)	PV of Cash Flows
1	2	3	4	5	6	7	8	9	10	11	12
	₹	₹	₹	₹	₹	₹	₹	₹	₹	₹	₹
0	-	-	-	-	-	-	-	100	(100)	1.00	(100)
1	(6.00)	30	24	(60)	-	(60)	-	30	(30)	0.87	(26.10)
2	34	30	24	(20)	-	(20)	10	-	10	0.76	7.60
3	54	30	24	-	-	-	30	-	30	0.66	19.80
4	74	30	24	20	-	20	50	50	-	0.57	-
5	108	30	18	60	-	60	90	50	40	0.50	20.00
6	142	30	12	100	50	50	80	50	30	0.43	12.90
7	156	30	6	120	60	60	90	50	40	0.38	15.20
8	230	30	-	200	100	100	130	-	130	0.33	42.90
9	330	30	-	300	150	150	180	-	180	0.28	50.40
10	430	30	-	400	200	200	230	-	230	0.25	57.50
										Net present value	<u>100.20</u>

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PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

Area B:

(₹ in lakhs)

Year	Profit (Loss) Before Interest & Depreciation	Depre-* ciation	Interest	PBT	Income Tax @ 50%	Profit After Tax	Cash Inflows	Cash outflows	Net Cash Flow	Present Value Factor (at 15%)	PV of Cash Flows
1	2	3	4	5	6	7	8	9	10	11	12
	₹	₹	₹	₹	₹	₹	₹	₹	₹	₹	₹
0	–	–	–	–	–	–	–	80	(80)	1.00	(80.00)
1	(50)	30	20	(100)	–	(100)	–	70	(70)	0.87	(60.90)
2	(50)	30	20	(100)	–	(100)	–	70	(70)	0.76	(53.20)
3	10	30	20	(40)	–	(40)	–	10	(10)	0.66	(6.60)
4	20	30	20	(30)	–	(30)	–	50	(50)	0.57	(28.50)
5	45	30	15	–	–	–	30	50	(20)	0.50	(10.00)
6	100	30	10	60	–	60	90	50	40	0.43	17.20
7	155	30	5	120	–	120	150	50	100	0.38	38.00
8	190	30	–	160	28	132	162	–	162	0.33	53.46
9	230	30	–	200	80	120	150	–	150	0.28	42.00
10	330	30	–	300	120	180	210	–	210	0.25	52.50
										Net present value	<u>(36.04)</u>

Advice: Gretel Ltd. should go for Area 'A' for location of new plant

Question 3

- (a) Gibralter Limited has imported 5000 bottles of shampoo at landed cost in Mumbai, of US \$ 20 each. The company has the choice for paying for the goods immediately or in 3 months time. It has a clean overdraft limited where 14% p.a. rate of interest is charged.

Calculate which of the following method would be cheaper to Gibraltar Limited.

- (i) Pay in 3 months time with interest @ 10% and cover risk forward for 3 months.
 (ii) Settle now at a current spot rate and pay interest of the overdraft for 3 months.

The rates are as follow :

Mumbai ₹/\$ spot	:	60.25-60.55
3 months swap	:	35/25

(8 Marks)

- (b) The risk free rate of return R_f is 9 percent. The expected rate of return on the market portfolio R_m is 13 percent. The expected rate of growth for the dividend of Platinum Ltd. is 7 percent. The last dividend paid on the equity stock of firm A was ₹ 2.00. The beta of Platinum Ltd. equity stock is 1.2.

- (i) What is the equilibrium price of the equity stock of Platinum Ltd.?
 (ii) How would the equilibrium price change when

- The inflation premium increases by 2 percent?
- The expected growth rate increases by 3 percent?
- The beta of Platinum Ltd. equity rises to 1.3?

(8 Marks)

Answer

- (a) Option - I

$$\$20 \times 5000 = \$ 1,00,000$$

$$\text{Repayment in 3 months time} = \$1,00,000 \times (1 + 0.10/4) = \$ 1,02,500$$

$$\text{3-months outright forward rate} = ₹ 59.90/ ₹ 60.30$$

$$\text{Repayment obligation in ₹} (\$1,02,500 \times ₹ 60.30) = ₹ 61,80,750$$

Option -II

$$\text{Overdraft } (\$1,00,000 \times ₹60.55) \quad ₹ 60,55,000$$

$$\text{Interest on Overdraft } (₹60,55,000 \times 0.14/4) \quad ₹ 2,11,925$$

$$\underline{₹ 62,66,925}$$

Option I should be preferred as it has lower outflow.

(b) (i) Equilibrium price of Equity using CAPM

$$= 9\% + 1.2(13\% - 9\%)$$

$$= 9\% + 4.8\% = 13.8\%$$

$$P = \frac{D_1}{k_e - g} = \frac{2.00(1.07)}{0.138 - 0.07} = \frac{2.14}{0.068} = ₹ 31.47$$

(ii) New Equilibrium price of Equity using CAPM

$$= 9.18\% + 1.3(13\% - 9.18\%)$$

$$= 9.18\% + 4.966\% = 14.146\%$$

$$P = \frac{D_1}{k_e - g} = \frac{2.00(1.10)}{0.14146 - 0.10} = \frac{2.20}{0.04146} = ₹ 53.06$$

Question 4

(a) *Beanstalk Ltd. manages its accounts receivable internally by its sales and credit department. The cost of sales ledger administration stands at ₹ 10 crores annually. The company has a credit policy of 2/10, net 30. Past experience of the company has been that on an average 40 percent of the customers avail of the discount by paying within 10 days while the balance of the receivables are collected on average 90 days after the invoice date. Bad debts of the company are currently 1.5 percent of total sales. The projected sales for the next year are ₹ 1,000 crores.*

Beanstalk Ltd. finances its investment in debtors through a mix of bank credit and own long term funds in the ratio of 70:30. The current cost of bank credit and long term funds are 13 percent and 15 percent respectively.

With escalating cost associated with the in house management of debtors coupled with the need to unburden the management with the task so as to focus on sales promotion, the Company is examining the possibility of outsourcing its factoring service for managing its receivable and has two proposals on hand with a guaranteed payment within 30 days.

The main elements of the Proposal I from Finebank Factors Ltd. are:

- *Advance, 88 percent and 84 percent for the recourse and non recourse arrangements.*
- *Discount charge in advance, 21 percent for with recourse and 22 percent without recourse.*
- *Commission, 4.5 percent without recourse and 2.5 percent with recourse.*

The main elements of the Proposal II from Roughbank Factors Ltd. are:

- *Advance, 84 percent with recourse and 80 percent without recourse respectively.*

- Discount charge upfront without recourse 21 percent and with recourse 20 percent.
- Commission upfront, without recourse 3.6 percent and with recourse 1.8 percent.

The opinion of the Chief Marketing Manager is that in the context of the factoring arrangement, his staff would be able exclusively focus on sales promotion which would result in additional sales of 10% of projected sales. Kindly advice as a financial consultant on the alternative proposals. What advice would you give? Why? (12 Marks)

- (b) Cinderella Mutual Fund has the following assets in Scheme Rudolf at the close of business on 31st March, 2014.

Company	No. of Shares	Market Price Per Share
Nairobi Ltd.	25000	₹ 20
Dakar Ltd.	35000	₹ 300
Senegal Ltd.	29000	₹ 380
Cairo Ltd.	40000	₹ 500

The total number of units of Scheme Rudolf are 10 lacs. The Scheme Rudolf has accrued expenses of ₹ 2,50,000 and other liabilities of ₹ 2,00,000. Calculate the NAV per unit of the Scheme Rudolf. (4 Marks)

Answer

- (a) Financial Analysis of Receivable Management Alternatives

(A) In-House Management

	(₹Crores)
Cash Discount (₹1000 crore x 40% x 2%)	8.00
Bad Debt (₹1000 crore x 1.50%)	15.00
Avoidable Administrative and Selling Cost	10.00
Cost of Investment in Receivable*	21.61
	54.61

* Cost of Investment in Receivable

Average Collection Period (0.40 x 10 + 0.60 x 90)	58 days
Investment in Debtors (₹ 1000 crores x 58/365)	₹ 158.90 crores
Cost of Investment (0.70 x 13 + 0.30 x 15)	13.60%
Cost of Investment in Receivable (₹ 158.90 crores x 13.60%)	₹ 21.61 crores

(B) Finebank Proposal

	<i>With Recourse</i>	<i>Without Recourse</i>
Factoring Commission (₹1100 crores x 2.5%) and (₹1100 crores x 4.5%)	27.50	49.50
Discount Charges (₹1100 crores – ₹27.50 crores) 0.88 x 21% x 30/365	16.29	-
(₹1100 crores – ₹49.50 crores) 0.84 x 22% x 30/365	-	15.96
Cost of Long Term Funds Invested in Debtors (₹1100 crores – ₹943.80 crores) 0.15 x 30/365	1.93	-
(₹1100 crores – ₹882.42 crores) 0.15 x 30/365	-	2.68
	45.72	68.14

(C) Roughbank Proposal

	<i>With Recourse</i>	<i>Without Recourse</i>
Factoring Commission (₹1100 crores x 1.8%) and (₹1100 crores x 3.6%)	19.80	39.60
Discount Charges (₹1100 crores – ₹19.80 crores) 0.84 x 20% x 30/365	14.92	-
(₹1100 crores – ₹39.60 crores) 0.80 x 21% x 30/365	-	14.64
Cost of Long Term Funds Invested in Debtors (₹1100 crores – ₹907.37 crores) 0.15 x 30/365	2.37	-
(₹1100 crores – ₹848.32 crores) 0.15 x 30/365	-	3.10
	37.09	57.34

Decision Analysis: With Recourse

	<i>Fine bank</i>	<i>Rough bank</i>
Benefits (₹54.61 crore – ₹15 crore [†])	39.61	39.61
Costs	45.72	37.09
	(6.11)	2.52

† Bad Debts

Decision Analysis: Without Recourse

	<i>Fine bank</i>	<i>Rough bank</i>
Benefits	54.61	54.61
Costs	68.14	57.34
	(13.53)	(2.73)

Advice: The proposal of Roughbank with recourse should be accepted.

(b)

<i>Shares</i>	<i>No. of shares</i>	<i>Price</i>	<i>Amount (₹)</i>
Nairobi Ltd.	25,000	20.00	5,00,000
Dakar Ltd.	35,000	300.00	1,05,00,000
Senegal Ltd.	29,000	380.00	1,10,20,000
Cairo Ltd.	40,000	500.00	2,00,00,000
			4,20,20,000
Less: Accrued Expenses			2,50,000
Other Liabilities			2,00,000
Total Value			4,15,70,000
No. of Units			10,00,000
NAV per Unit (4,15,70,000/10,00,000)			41.57

Question 5

- (a) *Buenos Aires Limited has 10 lakh equity shares outstanding at the beginning of the year 2013. The current market price per share is ₹ 150. The current market price per share is ₹ 150. The company is contemplating a dividend of ₹ 9 per share. The rate of capitalization, appropriate to its risk class, is 10%.*
- (i) *Based on MM approach, calculate the market price of the share of the company when:*
- (1) *Dividend is declared*
 - (2) *Dividend is not declared*
- (ii) *How many new shares are to be issued by the company, under both the above options, if the Company is planning to invest ₹ 500 lakhs assuming a net income of ₹ 200 lakhs by the end of the year? (8 Marks)*
- (b) *Odessa Limited has proposed to expand its operations for which it requires funds of \$ 15 million, net of issue expenses which amount to 2% of the issue size. It proposed to raise the funds through a GDR issue. It considers the following factors in pricing the issue:*

- (i) The expected domestic market price of the share is ₹ 300
- (ii) 3 shares underly each GDR
- (iii) Underlying shares are priced at 10% discount to the market price
- (iv) Expected exchange rate is ₹ 60/\$

You are required to compute the number of GDR's to be issued and cost of GDR to Odessa Limited, if 20% dividend is expected to be paid with a growth rate of 20%. (8 Marks)

Answer

- (a) (i) As per MM model, the current market price of equity share is:

$$P_0 = \frac{1}{1 + k_e} \times (D_1 + P_1)$$

- (a) If the dividend is declared:

$$150 = \frac{1}{1 + 0.10} \times (9 + P_1)$$

$$150 = \frac{9 + P_1}{1.10}$$

$$165 = 9 + P_1$$

$$P_1 = 165 - 9 = ₹ 156$$

The market price of the equity share at the end of the year would be ₹ 156.

- (b) If the dividend is not declared:

$$150 = \frac{1}{1 + 0.10} \times (0 + P_1)$$

$$150 = \frac{P_1}{1.10}$$

$$P_1 = ₹ 165$$

The Market price of the equity share at the end of the year would be ₹ 165.

- (ii) Number of new shares to be issued

- (a) If the dividend is declared: In case the firm pays dividend of ₹ 9 per share out of total profits of ₹ 2,00,00,000 and plans to make new investment of ₹ 500,00,000, the number of shares to be issued may be found as follows:

Total Earnings	₹ 2,00,00,000
- Dividends paid	<u>90,00,000</u>
Retained earnings	1,10,00,000

Total funds required	<u>5,00,00,000</u>
Fresh funds to be raised	<u>3,90,00,000</u>
Market price of the share	156
Number of shares to be issued ($\text{₹ } 3,90,00,000/156$)	2,50,000

- (b) If the dividend is not declared: In case the firm pays no dividend out of total profits of ₹2,00,00,000 and plans to make new investment of ₹5,00,00,000, the number of shares to be issued may be found as follows:

Total Earnings	₹ 2,00,00,000
- Dividends paid	<u>0</u>
Retained earnings	2,00,00,000
Total funds required	<u>5,00,00,000</u>
Fresh funds to be raised	<u>3,00,00,000</u>
Market price of the share	165
Number of shares to be issued ($\text{₹ } 3,00,00,000/165$)	1,81,818

- (b) Net Issue Size = \$15 million

$$\text{Gross Issue} = \frac{\$15 \text{ million}}{0.98} = \$15.306 \text{ million}$$

$$\text{Issue Price per GDR in ₹} (300 \times 3 \times 90\%) = ₹810$$

$$\text{Issue Price per GDR in \$} (\text{₹}810 / \text{₹}60) = \$13.50$$

$$\text{Dividend Per GDR (D}_1\text{)} = ₹2 \times 3 = ₹6$$

* Assumed to be on based on Face Value of ₹10 each share.

$$\text{Net Proceeds Per GDR} = ₹810 \times 0.98 = ₹793.80$$

- (a) Number of GDR to be issued

$$\frac{\$15.306 \text{ million}}{\$13.50} = 1.1338 \text{ million}$$

- (b) Cost of GDR to Odessa Ltd.

$$k_e = \frac{6.00}{793.80} + 0.20 = 20.76\%$$

Question 6

- (a) Cauliflower Limited is contemplating acquisition of Cabbage Limited. Cauliflower Limited has 5 lakh shares having market value of ₹ 40 per share while Cabbage Limited has 3 lakh shares having market value of ₹ 25 per share. The EPS for Cabbage Limited and

Cauliflower Limited are ₹ 3 per share and ₹ 5 per share respectively. The managements of both the companies are discussing two alternatives for exchange of shares as follows:

- (i) In proportion to relative earnings per share of the two companies.
- (ii) 1 share of Cauliflower Limited for two shares of Cabbage Limited.

Required:

- (i) Calculate the EPS after merger under both the alternatives.
 - (ii) Show the impact on EPS for the shareholders of the two companies under both the alternatives. (10 Marks)
- (b) An investor is holding 5,000 shares of X Ltd. Current year dividend rate is ₹ 3/share. Market price of the share is ₹ 40 each. The investor is concerned about several factors which are likely to change during the next financial year as indicated below:

	Current Year	Next Year
Dividend paid/anticipated per share (₹)	3	2.5
Risk free rate	12%	10%
Market Risk Premium	5%	4%
Beta Value	1.3	1.4
Expected growth	9%	7%

In view of the above, advise whether the investor should buy, hold or sell the shares.

(6 Marks)

Answer

- (a) (i) Exchange ratio in proportion to relative EPS

(in ₹)

Company	Existing No. of shares	EPS	Total earnings
Cauliflower Ltd.	5,00,000	5.00	25,00,000
Cabbage Ltd.	3,00,000	3.00	<u>9,00,000</u>
Total earnings			<u>34,00,000</u>

No. of shares after merger $5,00,000 + 1,80,000 = 6,80,000$

Note: 1,80,000 may be calculated as $= \left(3,00,000 \times \frac{3.00}{5.00} \right)$

EPS for Cauliflower Ltd. after merger $= \frac{34,00,000}{6,80,000} = ₹ 5.00$

Impact on EPS

<u>Cauliflower Ltd. shareholders</u>	₹
EPS before merger	5.00
EPS after merger	<u>5.00</u>
Increase/ Decrease in EPS	<u>0.00</u>
<u>Cabbage Ltd.' Shareholders</u>	
EPS before merger	3.00
EPS after the merger $5.00 \times 3/5$	<u>3.00</u>
Increase/ Decrease in EPS	<u>0.00</u>

(ii) Merger effect on EPS with share exchange ratio of 1 : 2

Total earnings after merger	₹ 34,00,000
No. of shares post merger $5,00,000 + 1,50,000 (0.5 \times 3,00,000)$	6,50,000
EPS $34,00,000 \div 6,50,000$	5.23

Impact on EPS

Cauliflower Ltd. shareholders	₹
EPS before merger	5.00
EPS after merger	<u>5.23</u>
Increase in EPS	<u>0.23</u>
Cabbage Ltd. shareholders	₹
EPS before merger	3.000
EPS after the merger 5.23×0.5	<u>2.615</u>
Decrease in EPS	<u>0.385</u>

- (b) On the basis of existing and revised factors, rate of return and price of share is to be calculated.

Existing rate of return

$$= R_f + \text{Beta} (R_m - R_f)$$

$$= 12\% + 1.3 (5\%) = 18.5\%$$

Revised rate of return

$$= 10\% + 1.4 (4\%) = 15.60\%$$

Price of share (original)

$$P_0 = \frac{D (1 + g)}{K_e - g} = \frac{3 (1.09)}{0.185 - 0.09} = \frac{3.27}{0.095} = ₹ 34.42$$

Price of share (Revised)

$$P_0 = \frac{2.50 (1.07)}{0.156 - 0.07} = \frac{2.675}{0.086} = ₹ 31.10$$

Market price of share of ₹40 is higher in comparison to current equilibrium price of ₹ 34.42 and revised equity price of ₹31.10. Under this situation investor should sell the share.

Question 7

Write short notes on any *four* of the following:

- (a) What are the signals that indicate that is time for an investor to exit a mutual fund scheme?
- (b) What is cross border leasing? State its objectives.
- (c) Explain Takeover by reverse bid.
- (d) What are the risks to which foreign exchange transactions are exposed?
- (e) Explain the term "Insider Trading" and why Insider Trading is punishable?

(4 x 4 = 16 Marks)

Answer

- (a) (1) When the mutual fund consistently under performs the broad based index, it is high time that it should get out of the scheme.
- (2) When the mutual fund consistently under performs its peer group instead of it being at the top. In such a case, it would have to pay to get out of the scheme and then invest in the winning schemes.
- (3) When the mutual fund changes its objectives e.g. instead of providing a regular income to the investor, the composition of the portfolio has changed to a growth fund mode which is not in tune with the investor's risk preferences.
- (4) When the investor changes his objective of investing in a mutual fund which no longer is beneficial to him.
- (5) When the fund manager, handling the mutual fund schemes, has been replaced by a new entrant whose image is not known.
- (b) Cross-border leasing is a leasing agreement where lessor and lessee are situated in different countries. This raises significant additional issues relating to tax avoidance and tax shelters.

Objectives of Cross Border Leasing

- Reduce the overall cost of financing through utilization by the lessor of tax depreciation allowances to reduce its taxable income.

- The lessor is often able to utilize nonrecourse debt to finance a substantial portion of the equipment cost. The debt is secured by among other things, a mortgage on the equipment and by an assignment of the right to receive payments under the lease.
 - Also, depending on the structure, in some countries the lessor can utilize very favourable “leveraged lease” financial accounting treatment for the overall transaction.
 - In some countries, it is easier for a lessor to repossess the leased equipment following a lessee default because the lessor is an owner and not a mere secured lender.
 - Leasing provides the lessee with 100% financing.
- (c) Generally, a big company takes over a small company. When the smaller company gains control of a larger one then it is called “Take-over by reverse bid”. In case of reverse take-over, a small company takes over a big company. This concept has been successfully followed for revival of sick industries.

The acquired company is said to be big if any one of the following conditions is satisfied:

- (i) The assets of the transferor company are greater than the transferee company;
- (ii) Equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital, and
- (iii) The change of control in the transferee company will be through the introduction of minority holder or group of holders.

Reverse takeover takes place in the following cases:

- (1) When the acquired company (big company) is a financially weak company
- (2) When the acquirer (the small company) already holds a significant proportion of shares of the acquired company (small company)
- (3) When the people holding top management positions in the acquirer company want to be relieved off of their responsibilities.

The concept of take-over by reverse bid, or of reverse merger, is thus not the usual case of amalgamation of a sick unit which is non-viable with a healthy or prosperous unit but is a case whereby the entire undertaking of the healthy and prosperous company is to be merged and vested in the sick company which is non-viable.

- (d) A firm dealing with foreign exchange may be exposed to the following types of risks:
- (i) **Transaction Exposure:** A firm may have some contractually fixed payments and receipts in foreign currency, such as, import payables, export receivables, interest payable on foreign currency loans etc. All such items are to be settled in a foreign

currency. Unexpected fluctuation in exchange rate will have favourable or adverse impact on its cash flows. Such exposures are termed as transactions exposures.

- (ii) **Translation Exposure:** The translation exposure is also called accounting exposure or balance sheet exposure. It is basically the exposure on the assets and liabilities shown in the balance sheet and which are not going to be liquidated in the near future. It refers to the probability of loss that the firm may have to face because of decrease in value of assets due to devaluation of a foreign currency despite the fact that there was no foreign exchange transaction during the year.
- (iii) **Economic Exposure:** Economic exposure measures the probability that fluctuations in foreign exchange rate will affect the value of the firm. The intrinsic value of a firm is calculated by discounting the expected future cash flows with appropriate discounting rate. The risk involved in economic exposure requires measurement of the effect of fluctuations in exchange rate on different future cash flows.
- (e) • The insider is any person who accesses the price sensitive information of a company before it is published to the general public. Insider includes corporate officers, directors, owners of firm etc. who have substantial interest in the company. Even, persons who have access to non-public information due to their relationship with the company such as internal or statutory auditor, agent, advisor, analyst consultant etc. who have knowledge of material, 'inside' information not available to general public. Insider trading practice is the act of buying or selling or dealing in securities by as a person having unpublished inside information with the intention of making abnormal profit's and avoiding losses. This inside information includes dividend declaration, issue or buy back of securities, amalgamation, mergers or take over, major expansion plans etc.
- The word insider has wide connotation. An outsider may be held to be an insider by virtue of his engaging himself in this practice on the strength of inside information.

Insider trading practices are lawfully prohibited. The regulatory bodies in general are imposing different fines and penalties for those who indulge in such practices. Based on the recommendation of Sachar Committee and Patel Committee, SEBI has framed various regulations and implemented the same to prevent the insider trading practices. Recently SEBI has made several changes to strengthen the existing Insider Trading Regulation, 1992 and new Regulation as SEBI (Prohibition of Insider Trading) Regulations, 2002 has been introduced. Insider trading which is an unethical practice resorted by those in power in corporates has manifested not only in India but elsewhere in the world causing huge losses to common investors thus driving them away from capital market. Therefore, it is punishable.