MAY 2010

FINAL (NEW COURSE)
GROUP-I PAPER-2
STRATEGIC FINANCIAL MANAGEMENT

Roll No..............................

Total No. of Questions—5

Total No. of Printed Pages—6

Time Allowed—3 Hours

Maximum Marks—100

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Answers to questions are to be given only in English except in the case of candidates who have opted for Hindi medium. If a candidate who has not opted for Hindi medium, his answers in Hindi will not be valued.

Answer **all** questions.

Working notes should form part of the answer.

Wherever necessary suitable assumptions may be made by the candidates.

Marks

1. (a) XY Ltd. has under its consideration a project with an initial investment of Rs. 1,00,000. Three probable cash inflow scenarios with their probabilities of occurrence have been estimated as below : 12

Annual cash inflow (Rs.)	20,000	30,000	40,000
Probability	0.1	0.7	0.2

The project life is 5 years and the desired rate of return is 20%. The estimated terminal values for the project assets under the three probability alternatives, respectively, are Rs. 0, 20,000 and 30,000.

You are required to :

(i) Find the probable NPV;

Marks

(ii) Find the worst-case NPV and the best-case NPV; and

(iii) State the probability occurrence of the worst case, if the cash flows are perfectly positively correlated over time.

(b) Mr. A purchased a 3-month call option for 100 shares in XYZ Ltd. at a premium of Rs. 30 per share, with an exercise price of Rs. 550. He also purchased a 3 month put option for 100 shares of the same company at a premium of Rs. 5 per share with an exercise price of Rs. 450. The market price of the share on the date of Mr. A's purchase of options, is Rs. 500. Calculate the profit or loss that Mr. A would make assuming that the market price falls to Rs. 350 at the end of 3 months. 4

(c) Explain briefly, how financial policy is linked to strategic management. 4

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

	Quote A	Quote B
Lease term	3 years	4 years
Initial lease rent (Rs. lakhs)	5.00	1.00
Annual lease rent (payable in arrears)		
(Rs. 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.

Marks

(b) Based on the following information, determine the NAV of a regular income scheme on per unit basis : 6

	Rs. Crores
Listed shares at Cost (ex-dividend)	20
Cash in hand	1.23
Bonds and debentures at cost	4.3
Of these, bonds not listed and quoted	1
Other fixed interest securities at cost	4.5
Dividend accrued	0.8
Amount payable on shares	6.32
Expenditure accrued	0.75
Number of units (Rs. 10 face value)	20 lacs
Current realizable value of fixed income securities of face value of Rs. 100	106.5
The listed shares were purchased when Index was	1,000
Present index is	2,300
Value of listed bonds and debentures at NAV date	8

There has been a diminution of 20% in unlisted bonds and debentures

Other fixed interest securities are at cost.

(c) How is a stock market index calculated ? Indicate any two important stock market indices. 4

Marks

3. (a) The following information is given for 3 companies that are identical except for their capital structure : 12

	Orange	Grape	Apple
Total invested capital	1,00,000	1,00,000	1,00,000
Debt/assets ratio	0.8	0.5	0.2
Shares outstanding	6,100	8,300	10,000
Pre tax cost of debt	16%	13%	15%
Cost of equity	26%	22%	20%
Operating Income (EBIT)	25,000	25,000	25,000
Net Income	8,970	12,350	14,950

The tax rate is uniform 35% in all cases.

(a) Compute the Weighted average cost of capital for each company.

(b) Compute the Economic Valued Added (EVA) for each company.

(c) Based on the EVA, which company would be considered for best investment ? Give reasons.

(d) If the industry PE ratio is 11x, estimate the price for the share of each company.

(e) Calculate the estimated market capitalisation for each of the Companies.

(b) The rate of inflation in India is 8% per annum and in the U.S.A. it is 4%. The current spot rate for USD in India is Rs. 46. What will be the expected rate after 1 year and after 4 years applying the Purchasing Power Parity Theory. 4

(c) List and briefly explain the main functions of an investment bank. 4

Marks

4\. (a) T Ltd. and E Ltd. are in the same industry. The former is in negotiation for acquisition of the latter. Important information about the two companies as per their latest financial statements is given below : 16

	T Ltd.	E Ltd.
Rs. 10 Equity shares outstanding	12 lakhs	6 lakhs
Debt :		
10% Debentures (Rs. lakhs)	580	—
12.5% Institutional Loan (Rs. lakhs)	—	240
Earnings before interest, depreciation and Tax (EBIDTA) (Rs. lakhs)	400.86	115.71
Market Price/share (Rs.)	220.00	110.00

T Ltd. plans to offer a price for E Ltd., business as a whole which will be 7 times EBIDTA reduced by outstanding debt, to be discharged by own shares at market price.

E Ltd. is planning to seek one share in T Ltd. for every 2 shares in E Ltd. based on the market price. Tax rate for the two companies may be assumed as 30%.

Calculate and show the following under both alternatives — T Ltd.'s offer and E Ltd.'s plan :

(i) Net consideration payable.

(ii) No. of shares to be issued by T Ltd.

(iii) EPS of T Ltd. after acquisition.

(iv) Expected market price per share of T Ltd. after acquisition.

(v) State briefly the advantages to T Ltd. from the acquisition.
Calculations (except EPS) may be rounded off to 2 decimals in lakhs.

(b) Briefly explain what is an exchange traded fund. 4

Marks

5. (a) Consider the following data for Government Securities : 8

Face Value (Rs.)	Interest Rate %	Maturity (Years)	Current Price (Rs.)
1,00,000	0	1	91,000
1,00,000	10.5	2	99,000
1,00,000	11.0	3	99,500
1,00,000	11.5	4	99,900

Calculate the forward interest rates.

(b) The following market data is available : 8

Spot USD/JPY 116.00

Deposit rates p.a.	USD	JYP
3 months	4.50%	0.25%
6 months	5.00%	0.25%

Forward Rate Agreement (FRA) for YEN is NIL.

1. What should be 3 months FRA rate at 3 months forward ?
2. 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 cases.

(c) Write a short note on Debt Securitisation. 4