

Roll No.

FINAL
GROUP-I PAPER-2
STRATEGIC FINANCIAL
MANAGEMENT

NOV. 2014

Total No. of Questions – 7

Total No. of Printed Pages – 8

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 has not opted for Hindi Medium, his/her answers in Hindi will not be valued.

Question No. 1 is compulsory.

Attempt any five out of the remaining six questions.

Wherever appropriate, suitable assumptions should be made and indicated in the answer by the candidate

Working Notes should form part of the answer.

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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.

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- (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. 5

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.

- (c) Elrond Limited plans to acquire Doom Limited. The relevant financial details of the two firms prior to the merger announcement are : 5

| | 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 ?

- (d) Goldilocks Ltd. was started a year back with equity capital of ₹ 40 lakhs. The other details are as under : 5

| | |
|-------------------------|------------|
| 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.

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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 lakh. However, he committed a mistake of using the book values of debt and equity. 6

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 market 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 ?

- (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. 10

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

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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 |

3. (a) Gibraltar 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 limit where 14% p.a. rate of interest is charged.

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

- Pay in 3 months time with interest @ 10% and cover risk forward for 3 months.
- 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 |

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- (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. 8
- (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 ?
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 ₹1000 crores. 12
- 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.

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- 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 ?

- (b) Cinderella Mutual Fund has the following assets in Scheme Rudolf at the close of business on 31st March, 2014. 4

| 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.

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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 company is contemplating a dividend of ₹ 9 per share. The rate of capitalization, appropriate to its risk class, is 10%. 8
- (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 ?
- (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: 8
- (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%.
6. (a) Cauliflower Limited is contemplating acquisition of Cabbage Limited. 10
- 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.

(8)

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- (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.

7. Write short notes on any four of the following :

4×4
=16

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

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