

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

Answer **all** questions.

Working notes should form part of the answer.

Wherever appropriate, suitable assumption should be made by the candidates.

Question 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:

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:

- Find the probable NPV;
 - Find the worst-case NPV and the best-case NPV; and
 - State the probability occurrence of the worst case, if the cash flows are perfectly positively correlated over time. (12 Marks)
- (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 Marks)
- (c) Explain briefly, how financial policy is linked to strategic management. (4 Marks)

Answer

- (a) The expected cash flows of the project are as follows:

Year	Pr = 0.1	Pr = 0.7	Pr = 0.2	Total
	Rs.	Rs.	Rs.	Rs.
0	-10,000	-70,000	-20,000	-1,00,000
1	2,000	21,000	8,000	31,000
2	2,000	21,000	8,000	31,000
3	2,000	21,000	8,000	31,000
4	2,000	21,000	8,000	31,000
5	2,000	21,000	8,000	31,000
5	0	14,000	6,000	20,000

FINAL (NEW) EXAMINATION : MAY, 2010

- (i) NPV based on expected cash flows would be as follows:

$$= - \text{Rs. } 1,00,000 + \frac{\text{Rs. } 31,000}{(1+0.20)^1} + \frac{\text{Rs. } 31,000}{(1+0.20)^2} + \frac{\text{Rs. } 31,000}{(1+0.20)^3} + \frac{\text{Rs. } 31,000}{(1+0.20)^4} + \frac{\text{Rs. } 31,000}{(1+0.20)^5} + \frac{\text{Rs. } 20,000}{(1+0.20)^5}$$

$$= - \text{Rs. } 1,00,000 + \text{Rs. } 25,833.33 + \text{Rs. } 21,527.78 + \text{Rs. } 17,939.81 + \text{Rs. } 14,949.85 + \text{Rs. } 12,458.20 + \text{Rs. } 8,037.55$$

$$\text{NPV} = \text{Rs. } 746.52$$

- (ii) For the worst case, the cash flows from the cash flow column farthest on the left are used to calculate NPV

$$= - \text{Rs. } 10,000 + \frac{\text{Rs. } 2,000}{(1+0.20)^1} + \frac{\text{Rs. } 2,000}{(1+0.20)^2} + \frac{\text{Rs. } 2,000}{(1+0.20)^3} + \frac{\text{Rs. } 2,000}{(1+0.20)^4} + \frac{\text{Rs. } 2,000}{(1+0.20)^5}$$

$$= - \text{Rs. } 10,000 + \text{Rs. } 1,666.67 + \text{Rs. } 1,388.89 + \text{Rs. } 1,157.41 + \text{Rs. } 964.51 + \text{Rs. } 803.76$$

$$\text{NPV} = - \text{Rs. } 4,018.76$$

For the best case, the cash flows from the cash flow column farthest on the right are used to calculate NPV

$$= - \text{Rs. } 20,000 + \frac{\text{Rs. } 8,000}{(1+0.20)^1} + \frac{\text{Rs. } 8,000}{(1+0.20)^2} + \frac{\text{Rs. } 8,000}{(1+0.20)^3} + \frac{\text{Rs. } 8,000}{(1+0.20)^4} + \frac{\text{Rs. } 8,000}{(1+0.20)^5} + \frac{\text{Rs. } 6,000}{(1+0.20)^5}$$

$$= - \text{Rs. } 20,000 + \text{Rs. } 6,666.67 + \text{Rs. } 5,555.56 + \text{Rs. } 4,629.63 + \text{Rs. } 3,858.02 + \text{Rs. } 3,215.02 + \text{Rs. } 2,411.26$$

$$\text{NPV} = \text{Rs. } 6,336.16$$

- (iii) If the cash flows are perfectly dependent, then the low cash flow in the first year will mean a low cash flow in every year. Thus the possibility of the worst case occurring is the probability of getting Rs. 2,000 net cash flow in year 1 or 20%.

- (b) Since the market price at the end of 3 months falls to Rs. 350 which is below the exercise price under the call option, the call option will not be exercised. Only put option becomes viable.

Rs.

The gain will be:

Gain per share (Rs. 450 – Rs. 350)	100
Total gain per 100 shares	10,000
Cost or premium paid (Rs. 30 x 100) + (Rs. 5 x 100)	<u>3,500</u>
Net gain	<u>6,500</u>

- (c) The success of any business is measured in financial terms. Maximising value to the shareholders is the ultimate objective. For this to happen, at every stage of its operations including policy-making, the firm should be taking strategic steps with value-

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

maximization objective. This is the basis of financial policy being linked to strategic management.

The linkage can be clearly seen in respect of many business decisions. For example :

- (i) Manner of raising capital as source of finance and capital structure are the most important dimensions of strategic plan.
- (ii) Cut-off rate (opportunity cost of capital) for acceptance of investment decisions.
- (iii) Investment and fund allocation is another important dimension of interface of strategic management and financial policy.
- (iv) Foreign Exchange exposure and risk management.
- (v) Liquidity management
- (vi) A dividend policy decision deals with the extent of earnings to be distributed and a close interface is needed to frame the policy so that the policy should be beneficial for all.
- (vii) Issue of bonus share is another dimension involving the strategic decision.

Thus from above discussions it can be said that financial policy of a company cannot be worked out in isolation to other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth.

Question 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:*

	Quote A	Quote B
<i>Lease term</i>	3 years	4 years
<i>Initial lease rent (Rs. lakhs)</i>	5.00	1.00
<i>Annual lease rent (payable in arrears) (Rs.lakhs)</i>	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. (10 Marks)

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

	Rs. Crores
<i>Listed shares at Cost (ex-dividend)</i>	20
<i>Cash in hand</i>	1.23
<i>Bonds and debentures at cost</i>	4.3
<i>Of these, bonds not listed and quoted</i>	1

FINAL (NEW) EXAMINATION : MAY, 2010

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.	
(6 Marks)	

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

Answer

(a)

(in lakhs)		
	Quote A	Quote B
Calculation of Present Value (PV) of cash payments:		
Initial lease rent (PV)	5.00	1.00
Less: PV of tax benefit on initial payment of lease rent		
Rs. 5.00 lakh x 0.30 x 0.91	(1.365)	-
Rs. 1.00 lakh x 0.30 x 0.91	-	(0.273)
PV of Annual lease rents		
Rs. 21.06 lakh x 0.7 x 2.49	36.71	-
Rs. 19.66 lakh x 0.7 x 3.17	-	43.63
Total payments in PV	40.345	44.357
Capital Recovery Factor (reciprocal of Annuity Factor)		
1/2.49	0.402	-
1/3.17	-	0.315
Equated Annual Payment or cash outflow (Rs. lakhs)	16.22	13.97

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

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

(b)

Particulars	Adjustment Value Rs. crores
Equity Shares	46.00
Cash in hand	1.23
Bonds and debentures not listed	0.80
Bonds and debentures listed	8.00
Dividends accrued	0.80
Fixed income securities	4.50
Sub total assets (A)	61.33
Less: Liabilities	
Amount payable on shares	6.32
Expenditure accrued	0.75
Sub total liabilities (B)	7.07
Net Assets Value (A) – (B)	54.26
No of units	20,00,000
Net Assets Value per unit (Rs. 54.26 crore / 20,00,000)	Rs. 271.30

(c) Stock Market Index

1. A base year is set alongwith a basket of base shares.
2. The changes in the market price of these shares is calculated on a daily basis.
3. The shares included in the index are those shares which are traded regularly in high volume.
4. In case the trading in any share stops or comes down then it gets excluded and another company's shares replace it.
5. Following steps are involved in calculation of index on a particular date:
 - Calculate market capitalization of each individual company comprising the index.
 - Calculate the total market capitalization by adding the individual market capitalization of all companies in the index.
 - Computing index of next day requires the index value and the total market capitalization of the previous day and is computed as follows:

$$\text{Index Value} = \text{Index on Previous Day} \times \frac{\text{Total market capitalisation for current day}}{\text{Total capitalisation of the previous day}}$$

FINAL (NEW) EXAMINATION : MAY, 2010

- It should also be noted that Indices may also be calculated using the price weighted method. Here the share the share price of the constituent companies form the weights. However, almost all equity indices world-wide are calculated using the market capitalization weighted method.

Each stock exchange has a flagship index like in India Sensex of BSE and Nifty of NSE and outside India is Dow Jones, FTSE etc.

Question 3

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

	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.

- (i) Compute the Weighted average cost of capital for each company.
- (ii) Compute the Economic Valued Added (EVA) for each company.
- (iii) Based on the EVA, which company would be considered for best investment? Give reasons.
- (iv) If the industry PE ratio is 11x, estimate the price for the share of each company.
- (v) Calculate the estimated market capitalisation for each of the Companies. (12 Marks)
- (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 Marks)
- (c) List and briefly explain the main functions of an investment bank. (4 Marks)

Answer

- (a) (i) Working for calculation of WACC

	Orange	Grape	Apple
Total debt	80,000	50,000	20,000
Post tax Cost of debt	10.4%	8.45%	9.75%
Equity Fund	20,000	50,000	80,000

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

WACC

Orange:	$(10.4 \times 0.8) + (26 \times 0.2) =$	13.52%
Grape:	$(8.45 \times 0.5) + (22 \times 0.5) =$	15.225%
Apple:	$(9.75 \times 0.2) + (20 \times 0.8) =$	17.95%

(ii)

	Orange	Grape	Apple
WACC	13.52	15.225	17.95

EVA [EBIT (1-T)-(WACC x Invested Capital)]	2,730	1,025	-1,700
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(iii) Orange would be considered as the best investment since the EVA of the company is highest and its weighted average cost of capital is the lowest

(iv) Estimated Price of each company shares

	Orange	Grape	Apple
EBIT	Rs. 25,000	Rs. 25,000	Rs. 25,000
Interest	Rs. 12,800	Rs. 6,500	Rs. 3,000
Taxable Income	Rs. 12,200	Rs. 18,500	Rs. 22,000
Tax 35%	Rs. 4,270	Rs. 6,475	Rs. 7,700
Net Income	Rs. 7,930	Rs. 12,025	Rs. 14,300
Shares	6,100	8,300	10,000
EPS	1.3	1.448795	1.43
Stock Price (EPS x PE Ratio)	Rs. 14.30	Rs. 15.94	Rs. 15.73

Since the three entities have different capital structures they would be exposed to different degrees of financial risk. The PE ratio should therefore be adjusted for the risk factor.

(v) **Market Capitalisation**

Estimated Stock Price (Rs)	14.30	15.94	15.73
No. of shares	6,100	8,300	10,000
Estimated Market Cap (Rs)	87,230	1,32,302	1,57,300

(b) The differential inflation is 4%. Hence the rate will keep changing adversely by 4% every year. Assuming that the change is reflected at the end of each year, the rates will be:

End of Year	Rs.	Rs/USD
1	Rs. 46.00 x 1.04	47.84
2	Rs. 47.84 x 1.04	49.75

FINAL (NEW) EXAMINATION : MAY, 2010

3	Rs. 49.75 x 1.04	51.74
4	Rs. 51.74 x 1.04	53.81

Alternative Answer

End of Year	Rs.	Rs/USD
1	Rs. 46.00 x $\frac{(1+0.08)}{(1+0.04)}$	47.77
2	Rs. 47.77 x $\frac{(1+0.08)}{(1+0.04)}$	49.61
3	Rs. 49.61 x $\frac{(1+0.08)}{(1+0.04)}$	51.52
4	Rs. 51.52 x $\frac{(1+0.08)}{(1+0.04)}$	53.50

(c) Main Functions of an Investment Bank

The following are, briefly, a summary of investment banking functions:

- **Managing an IPO (Initial Public Offering):** This includes hiring managers to the issue, due diligence and marketing the issue.
- **Issue of debt:** When a company requires capital, it sometimes chooses to issue public debt instead of equity.
- **Mergers and Acquisitions:** Acting as intermediary between Acquirer and target company
- **Private Placement:** A private placement differs little from a public offering aside from the fact that a private placement involves a firm selling stock or equity to private investors rather than to public investors.
- **Financial Restructuring:** When a company cannot pay its cash obligations - it goes bankrupt. In this situation, a company can, of course, choose to simply shut down operations and walk away or, it can also restructure and remain in business.

Question 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:*

	T Ltd.	E Ltd.
Rs. 10 Equity shares outstanding	12 Lakhs	6 Lakhs
Debt:		
10% Debentures (Rs. Lakhs)	580	--

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

12.5% Institutional Loan (Rs. Lakhs)	--	240
Earning before interest, depreciation and tax (EBIDAT) (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 EBIDAT 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. (16 Marks)

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

Answer

(a) As per T Ltd.'s Offer

	<i>Rs. in lakhs</i>
(i) Net Consideration Payable	
7 times EBIDAT, i.e. 7 x Rs. 115.71 lakh	809.97
Less: Debt	<u>240.00</u>
	<u>569.97</u>
(ii) No. of shares to be issued by T Ltd	
Rs. 569.97 lakh / Rs. 220 (rounded off) (Nos.)	2,59,000
(iii) EPS of T Ltd after acquisition	
Total EBIDT (Rs. 400.86 lakh + Rs. 115.71 lakh)	516.57
Less: Interest (Rs. 58 lakh + Rs. 30 lakh)	<u>88.00</u>
	428.57
Less: 30% Tax	<u>128.57</u>
Total earnings (NPAT)	<u>300.00</u>
 Total no. of shares outstanding (12 lakh + 2.59 lakh)	 14.59 lakh
EPS (Rs. 300 lakh / 14.59 lakh)	Rs. 20.56

FINAL (NEW) EXAMINATION : MAY, 2010

(iv) Expected Market Price:

	<i>Rs. in lakhs</i>
Pre-acquisition P/E multiple:	
EBIDAT	400.86
Less: Interest $580 \times \frac{10}{100}$	<u>58.00</u>
	342.86
Less: 30% Tax	<u>102.86</u>
	<u>240.00</u>
No. of shares (lakhs)	12.00
EPS	Rs. 20.00
Hence, PE multiple $\frac{220}{20}$	11
Expected market price after acquisition (Rs. 20.56 x 11)	Rs. 226.16

As per E Ltd's Plan

	<i>Rs. in lakhs</i>
(i) Net consideration payable	
6 lakhs shares x Rs. 110	660
(ii) No. of shares to be issued by T Ltd	
Rs. 660 lakhs ÷ Rs. 220	3 lakh
(iii) EPS of T Ltd after Acquisition	
NPAT (as per earlier calculations)	300.00
Total no. of shares outstanding (12 lakhs + 3 lakhs)	15 lakh
Earning Per Share (EPS) Rs. 300 lakh/15 lakh	Rs. 20.00
(iv) Expected Market Price (Rs. 20 x 11)	220.00
(v) Advantages of Acquisition to T Ltd	

Since the two companies are in the same industry, the following advantages could accrue:

- Synergy, cost reduction and operating efficiency.
- Better market share.
- Avoidance of competition.

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

- (b) Exchange Traded Funds (ETFs) were introduced in US in 1993 and came to India around 2002. ETF is a hybrid product that combines the features of an index mutual fund and stock and hence, is also called index shares. These funds are listed on the stock exchanges and their prices are linked to the underlying index. The authorized participants act as market makers for ETFs.

ETF can be bought and sold like any other stock on stock exchange. In other words, they can be bought or sold any time during the market hours at prices that are expected to be closer to the NAV at the end of the day. NAV of an ETF is the value of the underlying component of the benchmark index held by the ETF plus all accrued dividends less accrued management fees.

There is no paper work involved for investing in an ETF. These can be bought like any other stock by just placing an order with a broker.

Some other important features of ETF are as follows:

1. It gives an investor the benefit of investing in a commodity without physically purchasing the commodity like gold, silver, sugar etc.
2. It is launched by an asset management company or other entity.
3. The investor does not need to physically store the commodity or bear the costs of upkeep which is part of the administrative costs of the fund.

Question 5

- (a) Consider the following data for Government Securities:

Face value	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.

(8 Marks)

- (b) 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.

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

FINAL (NEW) EXAMINATION : MAY, 2010

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 case.

(8 Marks)

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

(4 Marks)

Answer

- (a) To get forward Interest rates, begin with the one year Government Security

$$\text{Rs. } 91,000 = \text{Rs. } 1,00,000 / (1 + r)$$

$$r = 0.099$$

Next consider the two year Government Security

$$\text{Rs. } 99,000 = (\text{Rs. } 10,500/1.099) + \{\text{Rs. } 1,10,500/(1.099)(1+r)\}$$

$$r = 0.124$$

Then consider the three year Government Security

$$\text{Rs. } 99,500 = (\text{Rs. } 11,000/1.099) + \{(\text{Rs. } 11,000/(1.099)(1.124))\} + \{\text{Rs. } 1,11,000/(1.099)(1.124)(1+r)\}$$

$$r = 0.115$$

Finally consider the four year Government Security

$$\text{Rs. } 99,900 = (\text{Rs. } 11,500/1.099) + \{(\text{Rs. } 11,500/(1.099)(1.124))\} + \{(\text{Rs. } 11,500/(1.099)(1.124)(1.115))\} + \{\text{Rs. } 1,11,500/(1.099)(1.124)(1.115)(1+r)\}$$

$$r = 0.128$$

- (b) 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%

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

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

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

(c) Debt Securitisation

Debt Securitisation is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this assets pool market securities can be issued.

The process can be classified in the following three functions:

1. **The origination function** – A borrower seeks a loan from finance company, bank, housing company or a financial institution. On the basis of credit worthiness repayment schedule is structured over the life of the loan.
2. **The pooling function** – Many similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special Purpose Vehicle), which acts as a trustee for the investor. Once the assets are transferred they are held in the organizers portfolios.
3. **The securitisation function** – It is the SPV's job to structure and issue the securities on the basis of asset pool. The securities carry coupon and an expected maturity, which can be asset base or mortgage based. These are generally sold to investors through merchant bankers. The investors interested in this type of securities are generally institutional investors like mutual fund, insurance companies etc. The originator usually keeps the spread available (i.e. difference) between yield from secured asset and interest paid to investors.

Generally the process of securitisation is without recourse i.e. the investor bears the credit risk of default and the issuer is under an obligation to pay to investors only if the cash flows are received by issuer from the collateral.