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IDEAL ANSWERS

CA Final

(Old Syllabus)

Management
Accounting & Financial
Analysis (MAFA)

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(Disclaimer: Questions asked in the exam may have wrong/inadequate information and/or ambiguous language. In that case the answers provided by institute may differ from this Ideal Answers. If you find any errors, please email the same.)

Question 1(a)

A company passes through three stage : growth transition and maturity, stage. The growth stage is expected to last for 2 years, while the transition stage lasts for 3 years. During the transition stage the growth rate of dividends changes from 18% to 9%. What would be the rate of dividend at the end of the first year of the transition stage? **(5 marks)**

Answer 1(a)

This question has ambiguous language also there is some missing information. If we assume that growth rate for the first two years is 18% and for the third year it is 9% and dividend for year zero was ₹1. Then dividend at the end of first year of the transition stage is =

$$1 \times (1.18)^2 \times (1.09)^1 = ₹1.52$$

Question 1(b)

M/s X Ltd. has paid a dividend of ₹2.5 per share on a face value of ₹10 in the financial year ending on 31st March, 2009. The details are as follows :

Current market price of Share	₹ 60
Growth rate of earnings and dividends	10%
Beta of Share	0.75
Average market return	15%
Risk free rate of return	9%

Calculate the intrinsic value of share.

(5 marks)

Answer 1(b)

$$E(R_p) = R_f + (R_M - R_f)\beta = 9\% + (15\% - 9\%)0.75 = 13.5\%$$

$$P_0 = \frac{D_1}{K_e - g} = \frac{2.5 \times (1.10)}{0.135 - 0.10} = \frac{2.75}{0.035} = \text{Rs. } 78.57$$

Question 1(c)

If the market price of the bond is ₹ 95; years to maturity = 6 yrs; coupon rate = 13% p.a. (paid annually) and issue price is ₹ 100. What is the yield to maturity? **(5 marks)**

Answer 1(c)

$$YTM = \frac{I + \frac{(R - P)}{n}}{\frac{R + P}{2}} = \frac{13 + \frac{100 - 95}{6}}{\frac{100 + 95}{2}} = 14.19\%$$

Question 1(d)

A convertible bond with a face value of ₹ 1,000 is issued at ₹ 1,350 with a coupon rate of 10.5%. The conversion rate is 14 shares per bond. The current market price of bond and share is ₹ 1,475 and ₹80 respectively. What is the premium over conversion value? **(5 marks)**

Answer 1(d)

Premium over conversion value

= Market price of convertible security – price at which security is convertible

$$₹ 1475 - ₹ 80 \times 14 = 1475 - 1120 = ₹ 355$$

Question 2(a)

F Ltd. is considering take-over of R Ltd. by the exchange of four new shares in P Ltd. for every five shares in R Ltd. The relevant financial details of the two companies prior to merger announcement are as follows :

	P Ltd.	R Ltd.
Profit before Tax (₹ Crore)	15	13.50
No. of Shares (Crore)	25	15
P/E Ratio	12	9

Corporate Tax Rate 30%

You are required to determine :

- Market value of both the company.
- Value of original shareholders.
- Price per share after merger.
- Effect on share price of both the company if the Directors of P Ltd. expect their own pre-merger P/E ratio to be applied to the combined earnings.

(10 marks)

Answer 2(a)

(i) & (ii) Market value of both the companies and original value of shareholders:

Particulars	P Ltd.	Q Ltd.
Profit before tax (₹ Crore)	15.00	13.50
Tax @30%	-4.50	-4.05
Profit after tax (₹ Crore)	10.50	9.45
No. of shares (Crore)	÷25.00	÷15.00
EPS(₹)	0.42	0.63
P/E Ratio	x12	x9
MPS(₹)	5.04	5.67
No. of shares	25.00	15.00
Market Value(₹ Crore)	126.00	85.05

(iii) Post merger market price:

Post merger EPS = $(10.5+9.45)/(25 + 15 \times 0.8) = 19.95/37 = 0.539$

Post merger MPS = Post merger EPS x P/E = $0.54 \times 12 = 6.47$

(iv) Effect on price:

For P Ltd. = Post merger price – Pre merger price = $6.47 - 5.04 = 1.43$

For R Ltd. = Post merger price x Exchange Ratio – Pre merger price = $6.47 \times 0.8 - 5.67 = -0.49$

Question 2(b)

Red Ltd. is considering a project with the following cash flows :

Years	Cost of plant	Recurring Cost	(₹) Savings
0	10,000		
1		4,000	12,000
2		5,000	14,000

The cost of Capital is 9% Measure the sensitivity of the Project to changes in the levels of plant value, running cost and savings (considering each factor at a time) such that the NPV becomes zero. The P.V. factor at 9% are as under :

Year	Factor
0	1
1	0.917
2	0.842

Which factor is the most sensitive to affect the acceptability of the project?

(6 marks)

Answer 2(b)

Calculation of NPV:

Year	PVF@9%	Cost of Plant	Recurring Cost	Savings
0	1	-10000	-	-
1	0.917	-	-4000	12000
2	0.842	-	-5000	14000
Present Value=		-10000	-7878	22792

Net Present Value = -10,000 – 7,878 + 22792 = ₹ 4914

Sensitivity Analysis:

(1) With respect to Cost of Plant:

to bring down the NPV to zero it should reduce by ₹ 4914 means Cost of plant should increase by ₹ 4914. Therefore:

% change = ₹ 4914/ ₹ 10000 = 49.14%

(2) With respect to Recurring Cost:

to bring down the NPV to zero present value of recurring cost should Increase by ₹ 4914. Therefore:

% change = ₹ 4914/ ₹ 7878 = 62.38%

(3) With respect to Savings:

to bring down the NPV to zero present value of savings should reduce by ₹ 4914. Therefore:

% change = ₹ 4914/ ₹ 22792= 21.56%

Conclusion: Savings are the most sensitive factor to affect acceptability of the proposal.

Question 3(a)

Aeroflot airlines is planning to procure a light commercial aircraft for flying class clients at an investment of ₹ 50 lakhs. The expected cash flow after tax for next three years is as follows :

(₹ in lakhs)

Year 1		Year 2		Year 3	
CFAT	Probability	CFAT	Probability	CFAT	Probability
15	.1	15	.1	18	.2
18	.2	20	.3	22	.5
22	.4	30	.4	35	.2
35	.3	45	.2	50	.1

The company wishes to consider all possible risk factors relating to an airline. The Company wants to know –

- (i) The expected NPV of this proposal assuming independent probability distribution with 6 per risk free rate of interest, and
- (ii) The possible deviation on expected values. (12 marks)

Answer 3(a)

Expected cash flow and Standard deviation of cash flows for **Year 1**:

CFAT	Prob.	CFAT x P	(CFAT-mean) ² x P
15	0.1	1.5	8.84
18	0.2	3.6	8.19
22	0.4	8.8	2.30
35	0.3	10.5	33.71
		24.4	53.04

$$\text{Mean} = \sum CFAT \times P = 24.4$$

$$\text{Standard Deviation} = \sqrt{(CFAT - \text{Mean})^2 \times P} = \sqrt{53.04} = 7.28$$

Expected cash flow and Standard deviation of cash flows for **Year 2**:

CFAT	Prob.	CFAT x P	(CFAT-mean) ² x P
15	0.1	1.5	8.84
20	0.3	6	5.81
30	0.4	12	12.54
45	0.2	9	84.87
		28.5	112.06

$$\text{Mean} = \sum CFAT \times P = 28.5$$

$$\text{Standard Deviation} = \sqrt{(CFAT - \text{Mean})^2 \times P} = \sqrt{112.06} = 10.59$$

Expected cash flow and Standard deviation of cash flows for **Year 3**:

CFAT	Prob.	CFAT x P	(CFAT-mean) ² x P
18	0.2	3.6	8.19
22	0.5	11	2.88
35	0.2	7	22.47
50	0.1	5	65.54
		26.6	99.08

$$\text{Mean} = \sum CFAT \times P = 26.6$$

$$\text{Standard Deviation} = \sqrt{\sum (CFAT - \text{Mean})^2 \times P} = \sqrt{99.08} = 9.95$$

Calculation of Net Present Value of the Project:

Year	Cash Flow	PVF@6%	PV
0	-50	1.000	-50.00
1	24.4	0.943	23.02
2	28.5	0.890	25.36
3	26.6	0.840	22.33
NPV=			20.72

Calculation of Standard Deviation (Risk) of the project:

Year	SD	PVF@6%	(SD x PV) ²
1	7.28	0.943	47.21
2	10.59	0.890	88.76
3	9.95	0.840	69.85
Total =			205.81

$$\text{Standard Deviation of project} = \sqrt{\sum_{i=1}^n \left[\frac{\sigma_i}{(1+r)^i} \right]^2} = \sqrt{205.81} = 14.35$$

Question 3(b)

An importer request his bank to extend the forward contract for US \$ 20,000 which is due for maturity on 30th October, 2010, for a further period of 3 months. He agrees to pay the required margin money for such extension of the contract.

Contracted Rate – US \$ 1 = ₹ 42.32

The US Dollar quoted on 30.10.2010 :-

Spot – 41.5000 / 41.5200

3 month's premium – 0.87% / 0.93%

Margin money for buying and selling rate is 0.075% and 0.20% respectively. Compute :

- (i) The cost to the importer in respect of the extension of the forward contract, and
- (ii) The rate of new forward contract. **(4 marks)**

Answer 3(b)

- 1) Originally bank entered into a forward sale contract at \$1= ₹ 42.32 due on 30th October, 2010.
- 2) Now on the due date bank will make spot purchase to cancel the above contract. Spot purchase can be made at the merchant bid rate (Interbank bid minus margin). As per FEDAI rules bank need not to load margin for this type of contract but language of the question suggests importer is ready to pay margin. Therefore cancellation rate will be 41.5000 – 0.075% = 41.47.

- 3) Cancellation charges may be calculated as follows:

Forward Sale by bank	= +42.32
Spot Purchase by bank	= <u>-41.47</u>
Net	+0.85
	X \$20,000
Net Receivable	₹ 17000

- 4) For extension bank will enter into 3 months forward sale contract at merchant ask rate as follows:

Spot Interbank ask rate	= ₹ 41.5200
Add: Premium@0.93%	= ₹ <u>00.3861</u>

Forward Interbank ask	= ₹ 41.9061
Add: Selling margin@0.20%	= ₹ <u>00.0838</u>

Forward Merchant ask	= ₹ 41.99
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- 5) Conclusion: Bank will recover ₹ 17,000 from the importer and will book a fresh forward sale contract for him at ₹ 41.99.

Question 4

An investor has decided to invest ₹ 1,00,000 in the shares of two companies, namely, ABC and XYZ. The projection of returns from the shares of the two companies along with their probabilities are as follows :-

Probability	ABC(%)	XYZ (%)
.20	12	16
.25	14	10
.25	-7	28
.30	28	-2

You are required to

- Comment on return and risk of investment in individual shares.
- Compare the risk and return of these two shares with a Portfolio of these shares in equal proportions.

Find out the proportion of each of the above shares to formulate a minimum risk portfolio. **(16 marks)**

Answer 4

Say the return of ABC is X and Return of XYZ is Y, then:

P	X	Y	XP	YP	$(X - \bar{X})$	$(Y - \bar{Y})$	$(X - \bar{X})^2 P$	$(Y - \bar{Y})^2 P$	$(X - \bar{X})(Y - \bar{Y})P$
0.20	12	16	2.40	3.20	-0.55	3.90	0.06	3.04	-0.43
0.25	14	10	3.50	2.50	1.45	-2.10	0.53	1.10	-0.76
0.25	-7	28	-1.75	7.00	-19.55	15.90	95.55	63.20	-77.71
0.30	28	-2	8.40	-0.60	15.45	-14.10	71.61	59.64	-65.35
			12.55	12.10			167.75	126.99	-144.26

(i) Return and risk of Individual shares:

$$\text{Return of ABC} = R_1 = \sum XP = 12.55\%$$

$$\text{Return of XYZ} = R_2 = \sum YP = 12.10\%$$

$$\text{Risk of ABC} = \sigma_1 = \sqrt{\sum (X - \bar{X})^2 P} = \sqrt{167.75} = 12.95$$

$$\text{Risk of XYZ} = \sigma_2 = \sqrt{\sum (Y - \bar{Y})^2 P} = \sqrt{126.99} = 11.27$$

Comment: ABC has higher return and higher risk, while XYZ has lower return and lower risk.

(ii) Risk and return of equal proportion portfolio:

$$\text{Covariance between two shares} = (X - \bar{X})(Y - \bar{Y})P = -144.26$$

$$\text{Correlation} = \frac{\text{Cov}(X, Y)}{\sigma_X \sigma_Y} = \frac{-144.26}{12.95 \times 11.27} = -0.99$$

$$\text{Return of portfolio} = R_1 W_1 + R_2 W_2 = 12.55 \times 0.5 + 12.10 \times 0.5 = 12.33\%$$

$$\begin{aligned} \text{Risk of portfolio} &= \sqrt{(\sigma_1 W_1)^2 + (\sigma_2 W_2)^2 + 2\sigma_1 \sigma_2 W_1 W_2 r_{12}} \\ &= \sqrt{(12.95 \times 0.5)^2 + (11.27 \times 0.5)^2 + 2 \times 12.95 \times 11.27 \times 0.5 \times 0.5 \times -0.99} = 1.20 \end{aligned}$$

Comment: It is better to hold the portfolio of two securities in equal proportion rather than holding individual securities because portfolio return is between the two securities while portfolio risk is much lower due to negative correlation.

(iii) Minimum risk portfolio:

$$W_1 = \frac{\sigma_2^2 - \sigma_1 \sigma_2 r_{12}}{\sigma_1^2 + \sigma_2^2 - 2\sigma_1 \sigma_2 r_{12}} = \frac{11.27^2 - 12.95 \times 11.27 \times -0.99}{12.95^2 + 11.27^2 - 2 \times 12.95 \times 11.27 \times -0.99} = \frac{271.50}{583.69} = 0.465$$

$$W_2 = 1 - W_1 = 1 - 0.465 = 0.535$$

If we invest ₹ 46,500 in ABC and ₹ 53,500 in XYZ then it will give us a minimum risk portfolio.

Question 5(a)

A mutual fund company introduced two schemes i.e. Dividend plan (Plan-D) and Bonus plan (Plan-B). The face value of the unit is ₹10. On 01.04.2005 Mr. K. invested ₹2,00,000 each in Plan-D and Plan-B when the NAV was ₹ 38.20 and ₹35.60 respectively. Both the plans matured on 31.03.2010.

Particulars of dividend and bonus declared over the period are as follows :-

Date	Dividend %	Bonus Ratio	Net Asset Value (₹)	
30.09.2005	10		39.10	35.60
30.06.2006		1:5	41.15	36.25

31.03.2007	15		44.20	33.10
15.09.2008	13		45.05	37.25
30.10.2008		1:8	42.70	38.30
27.03.2009	16		44.80	39.10
11.04.2009		1:10	40.25	38.90
31.03.2010			40.40	39.70

What is the effective yield per annum in respect of the above two plan?

(10 marks)

Answer 5(a)

Dividend Reinvestment Plan:

Date	Dividend	NAV	Units Allotted	Total Units
1-4-2005				5235.60
30-9-2005	5236	39.10	133.90	5369.50
31-7-2007	8054	44.20	182.22	5551.73
15-9-2008	7217	45.05	160.21	5711.93
27-3-2009	9139	44.80	204.00	5915.93

Redemption Value = 5915.93 x ₹ 40.40 = ₹ 2,39,000

Initial Investment = ₹ 2,00,000

Total Return = ₹ 39,000

Annual Return = ₹ 39,000/5 = ₹ 7800

% Return = ₹ 7800 / ₹ 2,00,000 = 3.9% p.a.

If we calculate compounded annual return, it is as follows:

$$FV = PV(1 + r)^n \quad 239000 = 200000(1 + r)^5 \quad r = 3.63\% \text{ p.a.}$$

Bonus Plan:

Date	Bonus Units	Total Units
1-4-2005		5617.98
30-6-2005	1123.60	6741.57
30-10-2008	842.70	7584.27
11-4-2009	758.43	8342.70

Redemption Value = 8342.70 x ₹ 39.70 = ₹ 3,31,200

Initial Investment = ₹ 2,00,000

Total Return = ₹ 1,31,200

Annual Return = ₹ 1,31,200/5 = ₹ 26,240

% Return = ₹ 26,240 / ₹ 2,00,000 = 13.12% p.a.

If we calculate compounded annual return, it is as follows:

$$FV = PV(1 + r)^n \quad 331200 = 200000(1 + r)^5 \quad r = 10.61\% \text{ p.a.}$$

Question 5(b)

The earnings per share of a company is ₹10 and the rate of capitalization applicable to it is 10 percent. The company has three options of paying dividend i.e. (i) 50%, (ii) 75% and (iii) 100% calculate the market price of the share as per WALTER's model if it can earn a return of (a) 15, (b) 10 and (c) 5 percent on its retained earnings. **(6 marks)**

Answer 5(b)

Walter formula:

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

P = Current market price

D = Dividend per share

E = Earning per share

r = Rate of return

Ke = Capitalization rate (cost of equity)

Particulars	Payout 50%	Payout 75%	Payout 100%
Return 15%	$\frac{5 + \frac{.15}{.10}(10 - 5)}{0.10} = 125$	$\frac{7.5 + \frac{.15}{.10}(10 - 7.5)}{0.10} = 112.5$	$\frac{10 + \frac{.15}{.10}(10 - 10)}{0.10} = 100$
Return 10%	$\frac{5 + \frac{.10}{.10}(10 - 5)}{0.10} = 100$	$\frac{7.5 + \frac{.10}{.10}(10 - 7.5)}{0.10} = 100.0$	$\frac{10 + \frac{.10}{.10}(10 - 10)}{0.10} = 100$
Return 5%	$\frac{5 + \frac{.05}{.10}(10 - 5)}{0.10} = 75$	$\frac{7.5 + \frac{.05}{.10}(10 - 7.5)}{0.10} = 87.5$	$\frac{10 + \frac{.05}{.10}(10 - 10)}{0.10} = 100$

Question 6(a)

Sensex futures are traded at a multiple of 50. Consider the following quotations of Sensex futures in the 10 trading days during February 2009.

Day	High	Low	Closing
4.02.09	3306.4	3290.00	3296.50
05.02.09	3298.00	3262.50	3294.40
06.02.09	3256.20	3227.00	3230.40
07.02.09	3233.00	3201.50	3212.30
10.02.09	3281.50	3256.00	3267.50
11.02.09	3283.50	3260.00	3263.80
12.02.09	3315.00	3286.30	3292.00
14.02.09	3315.00	3257.10	3309.30
17.02.09	3278.00	3249.50	3257.80
18.02.09	3118.00	3091.40	3102.60

Abhishek bought one sensex futures contract on February, 04. The average daily absolute change in the value of contract is ₹ 10,000 and standard deviation of these changes is ₹ 2,000. The maintenance margin is 75% of initial margin. You are required to determine the daily balances in the margin account and payment on margin calls, if any. **(8 marks)**

Answer 6(a)

Language of this question is very ambiguous and also it appears that some information is missing. Therefore let us assume that Initial margin is ₹ 10,000 and maintenance margin is ₹ 7500 (10,000 x 75%).

Day	Closing	Change	Margin Change	Margin Call	Margin Balance
4-Feb	3,296.50	0.00	0	0	10,000
5-Feb	3,294.40	-2.10	-105	0	9,895
6-Feb	3,230.40	-64.00	-3,200	3,305	10,000
7-Feb	3,212.30	-18.10	-905	0	9,095
10-Feb	3,267.50	55.20	2,760	0	11,855
11-Feb	3,263.80	-3.70	-185	0	11,670
12-Feb	3,292.00	28.20	1,410	0	13,080
14-Feb	3,309.30	17.30	865	0	13,945
17-Feb	3,257.80	-51.50	-2,575	0	11,370
18-Feb	3,102.60	-155.20	-7,760	6,390	10,000

Question 6(b)

The share of Galaxy Ltd. of a face value of ₹ 10 is being quoted at ₹ 24. The company has a plan to make a right issue of one equity share for every four shares currently held at a premium of 40% per share. You are required to :

- Determine the minimum price that can be expected of share after the issue.
- Calculate the theoretical value of the rights alone.
- Show the effect of the right issue on the wealth of a shareholder who has 1500 shares, if.
 - He sells the entire rights, and
 - He ignores the rights.

(8 marks)**Answer 6(b)**

(i) Post right market price:

$$= \frac{\text{Pre Right price} \times \text{pre right no. of shares} + \text{Right issue price} \times \text{No. of right shares}}{\text{Pre right no. of shares} + \text{No. of right shares}}$$

$$= \frac{24 \times 4 + 14 \times 1}{4 + 1} = \frac{110}{5} = 22$$

(ii) Value of right alone = Post right market price – Right issue price
 = ₹ 22 - ₹ 14
 = ₹ 8

(iii) Effect on wealth of right issue:

(a) If he sells the entire right:

Pre right wealth	= ₹24 x 1500 = ₹36000
Post right wealth	= Post right market value of shares + Value of right
	= (22 x 1500) + (8 x 1500/4)
	= 33000+3000
	= ₹36000
Change in wealth	= Post right wealth – Pre right wealth
	= ₹36000 - ₹36000
	= NIL

(b) If he ignores the right: In this case he will not be able to realize value of right of ₹3000. Hence his wealth will reduce by ₹3000.

Question 7(a)

What is insider trading practice?

(4 marks)

Answer 7(a)

According to SEBI regulations when an insider buys or sells the shares of a listed company when in possession of any unpublished price-sensitive information is called insider trading.

An insider would be a person who is or was connected to the company and who is reasonably expected to have access to unpublished price-sensitive information in respect to the securities of that company.

"Price-sensitive information" has been defined as periodical financial results of companies, dividend declaration, issue or buy-back of securities, any major expansion plans or execution of new projects, amalgamation, mergers or takeovers, disposal of whole or substantial part of undertaking and significant changes in policies, plans or operations of the company.

Illegal insider- trading in India includes an insider giving counsel or tipping any outsider while in possession of such price-sensitive information. However, it need not be concluded that the persons connected to the company are barred from possessing, buying and selling its shares. They are permitted to deal in the securities of the company, provided they make adequate disclosure about the transaction to the regulator and the exchanges on which the shares are listed.

Question 7(b)

What are the features of Futures Contract ?

(4 marks)

Answer 7(b)

Futures are exchange-traded forward contracts. These are contracts to buy or sell an asset in future at a price agreed upon today. Following are the features of future contract distinct from a forward contract:

- **Customized vs. Standardized contract:** forward contracts are customized while futures contracts are standardized. Terms of forward contracts are negotiated between the buyer and the seller. While the terms of futures contracts are decided by the exchange on which these are traded.

- **Counter Party Risk:** in forward contracts there is a risk of counter party default. In case of futures the exchange becomes counter party to each trade and guarantees settlement.
- **Liquidity:** futures are much more liquid and their price are transparent as their price and volumes are reported in the media.
- **Squaring off:** a forward contract can be reversed with only the same counter party with whom it was entered into. A futures contract can be reversed on the screen of the exchange, as the latter is the counter party to all futures trades.
- **Margin requirements:** Unless otherwise mentioned in the contract, there is no need of security deposit or margin in case of forward contracts, while it is compulsory in future for both the buyer & seller.

The standard terms in any futures contract are:

- **Quantity** of the underlying asset
- **Quality** of the underlying asset (not required in case of financial futures)
- Expiration **date**
- The unit of **price** quotation (not the price)
- Minimum fluctuation in price (**tick** size)
- **Settlement** style

Question 7(c)

Explain briefly the salient features of Foreign Currency Convertible Bonds.

(4 marks)

Answer 7(c)

Foreign Currency Convertible Bonds (FCCB) are debt instruments issued in a currency different than the issuer's domestic currency with an option to convert them in common shares of the issuer company. It's a quasi debt instrument to raise foreign currency funds at attractive rate. FCCB acts like a bond by making regular coupon and principal payments; and also gives the bondholder an option to convert the bond into stock.

Salient Features :

1. FCCB is a quasi-debt instrument, which can be converted into a company's equity shares if the investor chooses to do so, at a pre-determined strike rate.
2. FCCB issues have a 'Call' and 'Put' option to suit the structure of the Bond. A call option entitles the issuer to " Call " the loan and make an early redemption. On the other hand, a put option entitles the lender to exercise
3. the option to convert the FCCB into equity, both the options are subject to RBI guidelines.
4. The interest component or coupon on FCCBs is generally 30 per cent -40 per cent less than on normal debt paper or foreign currency loans or ECBs. This translates to cost saving of approx 2-3 per cent p.a.
5. The coupon on bonds can also be zero as in case of zero coupon Bonds (ZCB) in view of attractiveness of options attached to them. In case of ZCB, the holder is basically interested in either conversion of the bonds in equity or capital appreciation.

6. The redemption of FCCB can be made at a premium or at par or even at a discount depending upon the coupon offered. The Present value of overall remaining cash flow determines the valuation of Bonds.
7. The Yield to Maturity (YTM) in case of FCCBs normally ranges from 2 per cent to 7 per cent.
8. FCCB are generally issued by Corporate, which have high promoter shareholding and hence do not perceive any risk of losing management control even after exercise of conversion option.
9. The pricing of the FCCB options is generally between 30 per cent to 70 per cent premium over the Current Market Price giving sufficient cushion to the issuer. The FCCB holder opts to convert the FCCB, in case the market price exceeds the option price or if there is an intent to make strategic investment by the lender irrespective of the stock price in market.
10. In many cases, the FCCB issuer as well looks forward to exercise of option by lender, so that there is no fund outflow on redemption. Instead the issuers reserves are inflated by receipt of premium. If however, the FCCB holders do not opt for conversion, the Issuer has either to reissue the bonds to same holder or scout for a new lender. This also gives an opportunity for debt restructuring.

Question 7(d)

What is reverse merger?

(4 marks)

Answer 7(d)**Process**

In a reverse takeover, shareholders of the private company purchase control of the public shell company and then merge it with the private company. The publicly traded corporation is called a "shell". The private company shareholders receive a substantial majority of the shares of the public company and control of its board of directors.

The transaction can be accomplished within weeks. If the shell is listed company, the private company does not go through an expensive and time-consuming formalities because this process was completed beforehand with the public company.

The private company's shareholders pay for the shell company by contributing their shares in the private company to the shell company that they now control. This share exchange and change of control completes the reverse takeover, transforming the formerly privately held company into a publicly held company.

Benefits

Going public through a reverse takeover allows a privately held company to become publicly held at a lesser cost.

In addition, a reverse takeover is less susceptible to market conditions. Conventional IPOs are risky for companies to undertake because the deal relies on market conditions, over which senior management has little control. If the market is off,

Drawbacks

Reverse takeovers always come with some history and some shareholders. Sometimes this history can be bad and manifest itself in the form of currently sloppy records, pending lawsuits and other unforeseen liabilities.