

Test Series: March, 2012

MOCK TEST PAPER – 2

FINAL COURSE: GROUP – I

PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

*Question No. 1 is compulsory. Attempt any **five** questions from the remaining **six** questions. Working notes should form part of the answer.*

Time Allowed – 3 Hours

Maximum Marks – 100

QUESTIONS

- 1 (a) RBI sold a 91 day T-bill of face value of ₹ 100 at an yield of 6%. What was the issue price? (5 Marks)

- (b) Mr. A is contemplating purchase of 1,000 equity shares of a Company. His expectation of return is 10% before tax by way of dividend with an annual growth of 5%. The Company's last dividend was ₹ 2 per share. Even as he is contemplating, Mr. A suddenly finds, due to a Budget announcement Dividends have been exempted from Tax in the hands of the recipients. But the imposition of Dividend Distribution Tax on the Company is likely to lead to a fall in dividend of 20 paise per share. A's marginal tax rate is 30%.

Required:

Calculate what should be Mr. A's estimates of the price per share before and after the Budget announcement? (5 Marks)

- (c) An importer requests 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 months' 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. (5 Marks)

- (d) L Ltd. and M Ltd. have the following risk and return estimates.

$$R_L = 20\%$$

$$R_M = 22\%$$

$$\sigma_L = 18\%$$

$$\sigma_M = 15\%$$

$$(\text{Correlation of Coefficient}) = r_{LM} = -1$$

Calculate the proportion of investment in L Ltd. and M Ltd. to minimise the risk of portfolio. (5 Marks)

2. (a) Dolphin GMBH has a paid-up ordinary share capital of €20,000,000 represented by 40 million shares of 50 Euro Cents (i.e. €0.50) each. Earnings after tax in the most recent year were €7,500,000 of which €2,500,000 was distributed as dividend. The current price/earnings ratio of these shares, as reported in the financial press, is 8.

The company is planning a major investment that will cost €20,250,000 and is expected to produce additional after-tax earnings over the foreseeable future at the rate of 15 per cent on the amount invested.

The necessary finance is to be raised by a rights issue to the existing shareholders at a price 25% below the current market price of the company's shares.

You are required to calculate:

- (i) The current market price of the shares already in issue;
- (ii) The price at which the rights issue will be made;
- (iii) The number of new shares that will be issued;
- (iv) The price at which the shares of the company should theoretically be quoted on completion of the rights issue (i.e. the 'ex-rights price'). (6 Marks)

- (b) Extracts from the recent financial statements of ABC Ltd. are given below.

	₹ '000	₹ '000
Turnover		21,300
Cost of sales		16,400
Gross Profit		4,900
Non-current assets		3,000
Current assets		
Inventory	4,500	
Trade receivables	3,500	8,000
Total Assets		11,000

Current Liabilities		
Trade payables	3,000	
Overdraft	3,000	6,000
Equity Shares	1,000	
Reserves	1,000	2,000
Debtentures		3,000
Total Liabilities		11,000

XYZ Fincorp, a factor has offered to manage the trade receivables of ABC Ltd. in a servicing and factor-financing agreement. XYZ expects to reduce the average trade receivables period of ABC from its current level to 35 days; to reduce bad debts from 0.9% of turnover to 0.6% of turnover; and to save ABC ₹ 40,000 per year in administration costs.

The XYZ would also make an advance to ABC of 80% of the revised book value of trade receivables. The interest rate on the advance would be 2% higher than the 7% that ABC currently pays on its overdraft. The XYZ would charge a fee of 0.75% of turnover on a with-recourse basis, or a fee of 1.25% of turnover on a non-recourse basis.

Assume that there are 365 days in a year and all sales and purchases are on credit.

(10 Marks)

3. (a) AB Ltd. is a firm of recruitment and selection consultants. It has been in the profession for 10 years and obtained a stock market listing 4 years ago. It has pursued a policy of aggressive growth and specializes in providing services to companies in high-technology and high growth sectors. It is all-equity financed by ordinary share capital of ₹ 500 lakh in shares of ₹ 20 face value.

The company's results to the end of March 2009 have just been announced. Profits before tax were ₹1,266 lakh. The Chairman's statement included a forecast that earnings might be expected to rise by 4%, which is a lower annual rate than in recent years. This is blamed on economic factors that have had a particularly adverse effect on high-technology companies.

YZ Ltd. is in the same business but has been established much longer. It serves more traditional business sectors and its earnings record has been erratic. Press comment has frequently blamed this on poor management and the company's shares have been out of favour with the stock market for some time. Its current earnings growth forecast is also 4% for the foreseeable future. YZ Ltd. has an

issued ordinary share capital of ₹1800 lakh in ₹100 shares. Pre-tax profits for the year to 31 March 2009 were ₹1,125 lakh.

AB Ltd. has recently approached the shareholders of YZ Ltd. with a bid of 5 new shares in AB Ltd. for every 6 YZ Ltd. shares. There is a cash alternative of ₹ 345 per share. Following the announcement of the bid, the market price of AB Ltd. shares fell 10% while the price of YZ Ltd. shares rose 14%. The P/E ratio and dividend yield for AB Ltd., YZ Ltd. immediately prior to the bid announcement are shown below.

2009				
High	Low	Company	P/E	Dividend yield %
425	325	AB Ltd.	11	2.4
350	285	YZ Ltd.	7	3.1

Both AB Ltd. and YZ Ltd. pay tax at 30%.

AB Ltd.'s post-tax cost of equity capital is estimated at 13% per annum and YZ Ltd.'s at 11% per annum.

Assuming that you are a shareholder in YZ Ltd. You have a large, but not controlling interest.

You bought the shares some years ago and have been very disappointed with their performance. Based on the information and merger terms available, plus appropriate assumptions, to forecast post-merger values, evaluate whether the proposed share-for-share offer is likely to be beneficial to shareholders in both AB Ltd. and YZ Ltd. Also identify why the price of share of AB Ltd. fell following the announcement of bid. (10 Marks)

- (b) Jacqueline Ltd., a manufacturer of cosmetic products, reported earnings per share of ₹ 21 in 2011, on which it paid dividends per share of ₹ 6.90. Earnings are expected to grow 15% a year from 2012 to 2016, during which period the dividend payout ratio is expected to remain unchanged. After 2016, the earnings growth rate is expected to drop to a stable 6%, and the payout ratio is expected to increase to 65% of earnings. The company has a beta of 1.40 currently, and is expected to have a beta of 1.10 after 2016. The Government Bond Rate is 6.25% and Market Risk Premium is 5.5%.

- What is the expected price of company's share at the end of 2016?
- What is the value of the share, using the two-stage dividend discount model? (6 Marks)

- (a) Suppose you are verifying a valuation done on an established company by a well-known analyst has estimated a value of ₹ 750 lakhs, based upon the expected free

cash flow next year, of ₹ 30 lakhs, and with an expected growth rate of 5%,.

You found that, he has made the mistake of using the book values of debt and equity in his calculation. While you do not know the book value weights he used, you have been provided following information:

- (a) Company has a cost of equity of 12%.
- (b) After-tax cost of debt of 6%.
- (c) The market value of equity is three times the book value of equity, while the market value of debt is equal to the book value of debt.

You are required to estimate the correct value of company. (6 Marks)

- (b) CQS plc is a UK company that sells goods solely within UK. CQS plc has recently tried a foreign supplier in Netherland for the first time and need to pay €250,000 to the supplier in six months' time. You as financial manager are concerned that the cost of these supplies may rise in Pound Sterling terms and has decided to hedge the currency risk of this account payable. The following information has been provided by the company's bank:

Spot rate (€ per £): 1.998 ± 0.002

Six months forward rate (€ per £): 1.979 ± 0.004

Money market rates available to CQS plc:

Borrowing Deposit

One year Pound Sterling interest rates: 6.1%- 5.4%

One year Euro interest rates: 4.0% -3.5%

Assuming CQS plc has no surplus cash at the present time you are required to evaluate whether a money market hedge, a forward market hedge or a lead payment should be used to hedge the foreign account payable. (10 Marks)

5. (a) Parker, a businessman is considering opening a second location of his business and has secured the property. He has determined his options for leasing property as: commit to a two-year lease at £500,000 per year or commit to a one-year lease at £600,000. At the beginning of the second year, Parker has a choice to cancel the two-year lease at a cost of £200,000 or continue with the lease. If he only signed a one-year lease initially, he has the option of renewing the lease for another year at £600,000.

Based on previous experience in the business and his research on the new location, Parker estimates there is a 40% chance that net profits (cash inflow) in the first year will be considered "good" and will amount to £1000,000; alternatively, they will only amount to £300,000. If profits in year one were "good", the chance of them being "good" in year two as well is 80%. However, if profits in year one were "bad", the probably of them being "bad" in year two as well is 90%. "Good" profits in year two

also amount to £1000,000; “bad” profits in year two also amount to £300,000.

Draw the decision and recommend to Parker what he should do. (10 Marks)

- (b) A has invested in three Mutual Fund Schemes as per details below:

	MF A	MF B	MF C
Date of investment	01.12.2009	01.01.2010	01.03.2010
Amount of investment	₹ 50,000	₹ 1,00,000	₹ 50,000
Net Asset Value (NAV) at entry date	₹ 10.50	₹ 10	₹ 10
Dividend received upto 31.03.2010	₹ 950	₹ 1,500	Nil
NAV as at 31.03.2010	₹ 10.40	₹ 10.10	₹ 9.80

Required:

What is the effective yield on per annum basis in respect of each of the three schemes to Mr. A upto 31.03.2010? (6 Marks)

6. (a) Mr. Tempest has the following portfolio of four shares:

Name	Beta	Investment ₹ Lac.
Oxy Rin Ltd.	0.45	0.80
Boxed Ltd.	0.35	1.50
Square Ltd.	1.15	2.25
Ellipse Ltd.	1.85	4.50

The risk free rate of return is 7% and the market rate of return is 14%.

Required.

- (i) Determine the portfolio return. (ii) Calculate the portfolio Beta. (10 Marks)

- (b) The current market price of an equity share of Penchant Ltd is ₹ 420. Within a period of 3 months, the maximum and minimum price of it is expected to be ₹ 500 and ₹ 400 respectively. If the risk free rate of interest be 8% p.a., what should be the value of a 3 months Call option under the “Risk Neutral” method at the strike rate of ₹ 450 ? Given $e^{0.02} = 1.0202$ (6 Marks)

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

- Buy-Outs.
- Social Cost Benefit Analysis.
- American Depository Receipts (ADRs).
- Asset Securitisation.
- Drawbacks of investments in Mutual Funds.

(4 × 4 = 16 Marks)