

Strategic Financial Management

Concept of α (Alpha)

α means excess return, excess return can mean different things, different context based on

1. Alpha Used for estimation

The return of the security is made of 3 components

- a) return - dependent on market return
- b) return - independent on market return

Regression analysis is statistical tool that helps to estimate value of the dependent variable and independent variable

α is derived from characteristic linear equation of the security.

$$R_s = \alpha + \beta R_m$$

Where

R_s = Return on security (dependent variable)

α = return of security independent of market return (constant)

β = Sensitivity of security return to market return (slope)

R_m = Return of market (independent variable)

α in this equation represents the return which the security is expected to generate over and above the return which it is expected to generate based on its dependence on the market.

The return of security is characterized by 3 parameters:

- 1. α
- 2. β
- 3. Market return

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$\alpha + \beta$ are ascertained for securities under consideration using past returns of market and securities.

Characteristic Market Line of each security under consideration is framed. Probable returns for market under different economic scenarios are estimated.

Regression equation is used to estimate probable returns for each security based on probable market returns.

2. α used for decision making.

α in this context means excess of expected return over required return.

Expected return will be estimated using Characteristic line for each security.

Required return will be computed using CAPM.

+ Alpha:

The investment is expected to give a return in excess of reward for assumed risk represents an investment opportunity.

- Alpha:

Securities with negative alpha signals selling opportunity.

0 alpha:

The investment is expected to earn just adequate for the risk taken.

3. α used for performance evaluation:
 α can be used for evaluating performance of portfolio manager/ portfolio/ security.

In this context, α is computed as the excess of actual return over required return.

$$\text{Alpha} = \text{Actual return} - \text{Required return}$$

Systematic & Unsystematic risk of a Security:

1. Find total risk of security. The total risk of a security is variance which can be split into systematic risk & unsystematic risk.

2. Find systematic risk (risk explained by index) It is that part of security variance explained by index. It can be found as security variance multiplied coefficient of Determination.

$$\text{Coefficient of Determination} = r^2$$

3. find unsystematic risk that is risk unexplained by index.

$$\text{Total variance} - \text{Variance explained by Index}$$

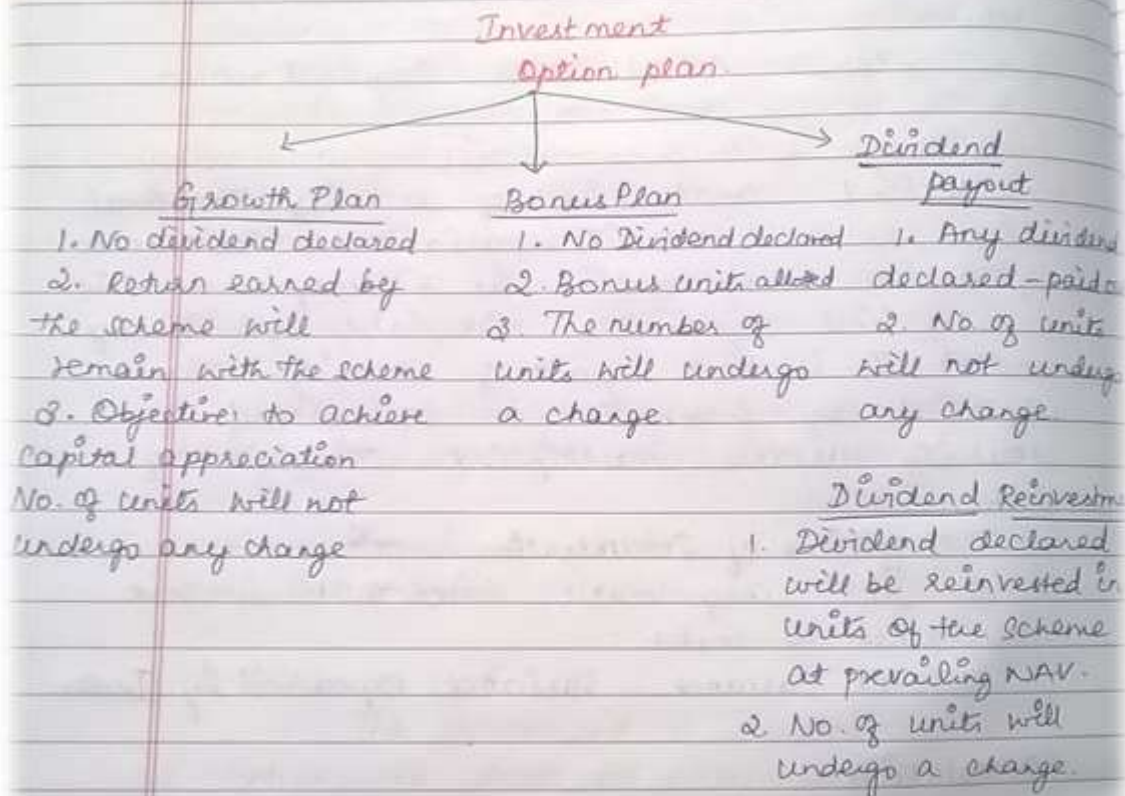
Correlation:

- or + signifies the direction
correlation coefficient - mere number.

Correlation coefficient is a pure number which gives direction & strength of 2 variables. It is a measure of how one variable can be expected to influence another variable. A non-zero correlation coefficient means that the variables are related unless it's +1 or -1 there are influences and the relation between 2 variables is not fixed, if you

know one can estimate the other but not with 100% confidence.

Beta reflects the direction & magnitude of relationship between 2 variables.



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Exchange Ratio = $\frac{\text{Market Value as per basis target Co.}}{\text{Value as per basis Acquiring Co.}}$

FREE FLOAT MARKET CAPITALISATION.

Free float market capitalisation takes into consideration only those shares issued by the company excludes locked in shares that do not come for securities market for trading purpose excludes

1. Promoters holding
2. Gov holding as promoter/acquirer
3. FDI holding
4. Equity held by group companies by employee welfare fund

Valuation

The process of linking return (expected return & risk) required return in order to determine the worth of an asset.

Equity Valuation

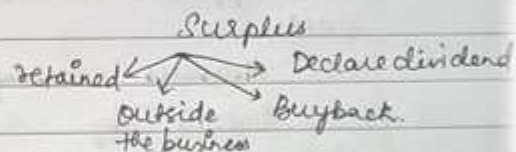
Absolute Valuation/

Discounted

This approach involves estimating the income you would receive from an investment and discount it appropriately for time value of money. Determines the asset's expected future cashflow.

Relative Valuation Models.

Determine the value based on MV of similar assets



Buyback:

- ① To increase promoter's holdings
- ② Cash are high
- ③ Share price is undervalued, to support market value

Sustainable growth rate:

Maximum rate at which a company can grow without having to raise new equity capital or increase financial leverage.

Although the companies can grow at extremely high rate, such rate cannot ^{typically} be sustained, valuation based on Discounted CFs models required growth rate that can be sustained for many years

$$\left. \begin{array}{l} \text{Sustainable} \\ \text{growth rate} \end{array} \right\} = \text{return on equity} (1 - \text{Dividend payout ratio})$$

$$g = \text{Retention ratio} \times \text{ROE}$$

Assumptions:

1. Company maintains its asset T/O & profitability.
2. Company maintains its capital structure
3. Company maintains its dividend policy

Economic Value Added.

Economic Value Added combines financial accounting and financial management concepts

Applies the logic of NPV to accounting data.

Measures earning efficiency.

Amount by which earnings exceed required minimum rate of return.

$$\left. \begin{array}{l} \text{Economic} \\ \text{Value Added} \end{array} \right\} = \frac{\text{Net Operating profit before tax} (1-t)}{\text{Invested capital}} - \text{WACC}$$

Bond Valuation.

Nominal yield / coupon yield:

Nominal yield / coupon yield is based on the coupon rate, it is interest as a % of par value / face value.

It is ^{the} stated rate of interest.

Current yield:

Current yield considers annual interest and current price of a bond, it represents the returns an investor will get at current market price & held for a year.

It is computed as
$$\frac{\text{Annual Interest}}{\text{Current price of the Bond}}$$

Required yield:

It is the minimum yield which the investor requires from a bond. It consists of 2 components:

1. Risk free rate - determined by the yield on govt securities.
2. Risk premium - determined by credit rating.

It is used as discount rate to find intrinsic value / fair value / equilibrium price or maximum price of the bond.

Yield to Maturity / Redemption yield:

Yield maturity is the internal rate of return earned by investor from date it is bought & till date of redemption.

Initial CF : Price of Bond

There are periodic inflows towards interest and also terminal CF when the bond

is redeemed.

It is Internal rate of return that considers the entire sequence of cashflows and their timing.

Situation	Relationship
Current price = Maturity Value	$YTM = \text{Coupon rate}$
Current price < Maturity Value	$YTM > \text{Coupon rate}$
Current price > Maturity Value	$YTM < \text{Coupon rate}$

If required yield is used as discount rate value can be found.

If YTM is used as discount rate price can be found.

Types of Risks associated with bonds:

1. Default Risk:

It is a risk that arises when the issuer is not able to satisfy timely payment of interest & repayment of principle. Government securities are considered default risk free and hence return on govt. securities are taken as risk free rate.

2. Interest rate risk:

Bond Investors are subject to interest rate risk on two counts:

- Reinvestment of periodic Interest
- Capital gain/loss, when interest rates

1. Periodic interest will be invested at a higher rate & hence there is a gain on reinvestment.

2. Market prices of the bond will come down hence there is a capital loss.

When interest rates fall:

1. Periodic interest invested at lower rate hence there is loss on reinvestment.

2. Market price of the bond will go up and hence there is a capital gain.

3. Price risk:

Combination of default risk & interest rate risk.

Duration:

The duration of a bond is a measure of the sensitivity of price to interest rate movements.

If bond is held for a period equal to duration interest rate risk disappears.

Units of duration are years. Duration is always between 0 to time to maturity of the bond.

Duration of a Zero Coupon Bond = Yield to Maturity.

Duration of Coupon carrying bond will be less than time to maturity.

~~Step~~

Steps to find duration:

1. Find year wise discounted cash inflow using YTM as discount rate
2. Current Market price = $\sum DCIF$
3. Multiply year and discounted cash inflow
4. Duration = $\frac{\sum (\text{Year} \times DCIF)}{\text{Current Market price}}$

$$\text{Volatility} = \frac{\text{Duration}}{1 + \text{YTM}}$$

$$\text{Expected } \Delta \text{ in price} = \text{CMP} \times \text{Volatility} \times \Delta \text{ in YTM}$$

$$\text{Expected Market price} = \text{Current Market Price} + \text{Expected } \Delta \text{ in price}$$

When YTM increases, Bond price decreases

$$\text{Expected Market price} = \text{Current Market Price} - \text{Expected change in price}$$

When YTM decreases, Bond price increases

$$\text{Expected Market price} = \text{Current Market Price} + \text{Expected change in price}$$

Call risk:

In a callable bond, bonds will be called back by the issuer in case of fall in interest rates in the market. This option gives the issuer the opportunity to redeem before the maturity date. The issuer exercise this option when he

gets funds at cheaper rate

Puttable Bonds provide an investor the right to seek redemption from the issuer prior to maturity.

Assumptions Underlying YTM:

1. All coupons & principal payments are made as per schedule.
2. The bond is held till maturity.
3. The coupon interest is full & immediately reinvested at YTM.

Realised Yield:

Return earned on a bond over the holding period.

YTM & realised yield will be equal if assumptions under YTM are fulfilled. Any violation of assumption will cause YTM to differ from realised yield, this is because the yield considers the returns that have been earned from reinvested interest.

Derivatives

Options:

Option holder has the right to exercise the option by paying the price - namely premium. He has the right but not the obligation. Option writer has the obligation but the right with regarding exercise of option. He sell by receiving premium, therefore he has the obligation: not the right.

Call option:

Call Option is an option to buy. The holder will exercise the option to buy the underlying asset if the exercise price is less than prevailing price. Writer - obligated to sell the underlying asset.

Physical settlement:

If Option exercised, holder will pay the exercise price. The writer will deliver.

Cash settlement:

If Option exercised, writer pays holder, the payoff $S_1 - E$ no delivery of the asset is made.

Put option:

The holder of the put option will exercise to sell the underlying asset if the exercise price is more than underlying.

The writer is obligated to buy the underlying asset at exercise price.

Physical Settlement:

If option exercised, holder will receive exercise price and deliver

Cash Settlement:

Writer pay the holder pay off
No delivery of asset.

Intrinsic Value / Theoretical Value:

The first component of option price. Intrinsic Value can never be negative.
for a call option, max of $S - E$
put option, max of $E - S$ or 0

Extrinsic Value / Time Value:

The second component of the options price. Time Value is over and above intrinsic value for a call option,
call option premium
✓ for a put option,
put option premium - intrinsic value

Forex

Direct quote is exchange rate expressed as per unit of foreign currency in terms of home currency.

Indirect quote is exchange rate expressed as so many units of foreign currency keeping home currency constant.

Types of Exposure:

1. Transaction / trading exposure arises whenever a currency has to be converted into another as a result of existing contractual obligation. This exposure has an impact on the income statement.
2. Balance sheet / accounting / translation exposure arises when an enterprise has assets / liabilities denominated in foreign currency and this has to be reported in domestic currency actual conversion does not take place.
3. Economic Exposure - effect of exchange rate movements on value of the business.

Capital Budgeting

1. When the life of the proposals are different decision has to be taken by comparing equivalent/equated annual cashflow.

2. RISK ADJUSTED DISCOUNT RATE APPROACH:

This approach is applied to evaluate proposals that involves different risk.

The discount rate for different proposals is determined by considering risk associated with each project.

Situation	Discount Rate
1. Risk of project = Normal accepted level of risk	K_e
2. Risk of project > Normal accepted level of risk	$> K_e$
3. Risk of project < Normal accepted level of risk	$< K_e$

Leasing

FINANCIAL EVALUATION OF Lease Vs. Borrowal by Lessee.

1. Find PV of cashflows associated with lease.

NOTE:

1. Lease rental should be shown as an OUTFLOW.
 2. Tax savings on lease rental should be shown as an INFLOW.
 3. Depreciation cannot be claimed for tax purposes irrespective of the type of lease.
2. Find PV of cashflow associated with purchasing the asset with borrowed funds.
1. Loan Instalment should be shown as an OUTFLOW.
 2. Tax savings on Interest should be shown as an INFLOW. If loan instalment is given as a Consolidated amount it has to be divided into principal and Interest.
 3. Tax savings on depreciation should be shown as an INFLOW.
 4. Salvage value net off tax should be considered as an INFLOW.
3. Select the Option for which PV of cashflow is less

Discount rate:

The DR to be employed is cost of debt that is $I \times (1-t)$ where I = Interest rate t = tax rate.

Portfolio Management

Regression Analysis - is a statistical tool that helps us to estimate, the values of one variable (dependent), with the values of another variable (independent), it is assumed that there exists a linear relationship between the two variables. here security is the dependent variable and Market is the independent variable.

The return of a security is made up of 2 components.

1. Return that is dependent on market return.

2. Return that is independent of the market return.

$$R_s = \alpha + \beta R_m$$

$$\beta = \frac{\text{Cov}_{sm}}{(\sigma_m)^2}$$

Whenever risk is to be split between systematic and unsystematic risk, Variance is to be taken as the measure of risk.

Systematic Risk & Unsystematic Risk of Security:

1. Find total risk of security (Variance)
2. Find Systematic risk = risk explained by the index.

Security Variance $\times$ Coefficient of determination $\rightarrow \sigma_m^2 \beta^2$

$$\text{Coefficient of determination} = (\text{Correlation})^2$$

3. Unsystematic risk - risk explained by index
$$= \text{total risk} - \text{systematic risk}$$

Systematic & Unsystematic risk for portfolio

Markowitz Model:

1. Find Total risk - variance of the portfolio using the formula.
2. Find portfolio beta

Which is the weighted average beta of the individual securities that constitute the portfolio. The investment proportion of each security should be taken as its weights.

3. Find systematic risk of portfolio that is $\text{market variance} \times (\text{portfolio beta})^2$

4. Find Unsystematic risk = $\text{Total risk} - \text{Systematic risk}$

Method 2:

Sharpe Index Model:

1. Find portfolio beta
2. Find systematic risk of portfolio
3. find variance of each security
4. find systematic risk of each security
5. find Unsystematic risk of each security
6. square investment prop. of each security
7. Find Unsystematic risk of portfolio that is total of product of Unsystematic risk $\times$ investment proportion squared.
8. Total risk of portfolio = systematic risk + Unsystematic risk.

Markowitz Model:

$$\text{Risk of portfolio} = \sqrt{(W_A)^2(\sigma_A)^2 + (W_B)^2(\sigma_B)^2 + 2(W_A)(W_B)(\sigma_A)(\sigma_B)\rho_{AB}}$$

For 3 securities portfolio:

$$= \sqrt{(W_A)^2(\sigma_A)^2 + (W_B)^2(\sigma_B)^2 + (W_C)^2(\sigma_C)^2 + 2(W_A)(W_B)(\sigma_A)(\sigma_B)\rho_{AB} + 2(W_B)(W_C)(\sigma_B)(\sigma_C)\rho_{BC} + 2(W_A)(W_C)(\sigma_A)(\sigma_C)\rho_{AC}}$$

Calculation of standard deviation:

1. Find return of various situations denoted as x
2. Find the probability of each situation denoted as P
3. Find Expected return, that is $\sum Px = \bar{x}$
4. Find deviation of each return from mean that is $x - \bar{x}$
5. Square the deviation $(x - \bar{x})^2$
6. Multiply the squared deviations with probability $P(x - \bar{x})^2$
7. Variance $= \sum P(x - \bar{x})^2$
8. Standard deviation $= \sqrt{\sum P(x - \bar{x})^2}$

Return & Risk of Security:

The return of a security is given by expected return, mean of the probability distribution / by average return which is the average of the past returns

Average of past returns will be the total return for past n years divided by ' n '

The risk of a security is measured by computing standard deviation.

Portfolio Return:

It is the weighted average return of the securities that constitute the portfolio.

The investment proportion of each security in each proportion has to be applied as weights.

Portfolio risk:

Portfolio risk is determined by

1. Risk of security in the portfolio.
2. Weight of each security in the portfolio.
3. Correlation that exists between every pair of securities in the portfolio.

∴ Portfolio risk is not the weighted average risk of the individual securities that constitute the portfolio.

Correlation:

Compute deviation of return of each security, from the respective means.

σ_A & σ_B

1. Find product of deviation $\sigma_A \times \sigma_B$
2. Multiply product with probability $P(\sigma_A \times \sigma_B)$
3. Covariance = $\sum P(\sigma_A \times \sigma_B)$
4. Correlation coefficient $\rho_{AB} = \frac{\text{Covariance}_{AB}}{\sigma_A \times \sigma_B}$

NOTE:-

For computing standard deviation, correlation etc,

- for past returns divided by 'n'
- instead of multiplying by probability

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$$\begin{array}{ccc} & \text{Beta Sensitivity} & \\ \downarrow & & \downarrow \\ \frac{\Delta \text{Return of Securities}}{\Delta \text{Return of Market}} & \frac{\text{Cov}_{sm}}{\sigma_m^2} & \frac{r_{sm} \times \sigma_s}{\sigma_m} \end{array}$$

Mutual Funds

Investment Options / Plans:

Growth Plans:

Dividend will not be declared.
The return earned by the scheme will remain with the scheme.
The objective of growth plan is to achieve capital appreciation.
The no. of units invested will not undergo any change.

Dividend Payout:

Under this plan, any dividend declared will be paid out.
The number of units will not any change.

Dividend Reinvestment:

Under this plan, dividend declared will be reinvested in the units of the scheme at the prevailing NAV.

Number of units will under a change.

Bonus Plan:

Under this plan, no dividends will be declared.

Bonus Units are allotted.

No. of units will undergo a change.

Mergers & Acquisition

Exchange ratio:

The exchange ratio is the no. of shares given by the acquiring company to shareholders of a target company for every share held in the target company.

Exchange ratio on a given basis
$$= \frac{\text{Value as per basis for target Co.}}{\text{Value as per basis for acquiring Co.}}$$

Exchange ratio = $\frac{\text{New shares issued to Target Co.}}{\text{Existing no. of shares in target Co.}}$

Note::

Earnings of the two companies should be added to find the earnings of the company post acquisition.

In the absence of information, PE ratio of acquiring company should be taken as PE ratio post acquisition.

Find gain/loss on

The shareholders of the acquiring company continue to be shareholders of the company post acquisition.

1. Find the preacquisition Market Value of the acquiring company.
2. Find the preacquisition Market Value of shareholders of the target company.
3. Find new shares issued by acquiring company to target company (that is existing shares in target company $\times$ Exchange ratio)
4. Find total no. of shares of the company post acquisition.
5. Find Market price of the company post acquisition.
6. Find Market Value of shareholders of the acquiring company who continue to be shareholders post acquisition.
7. Find Market Value of shareholders of target company post acquisition.
8. Find the gain/loss by comparing market value post acquisition and pre acquisition.

$\Rightarrow$ Market Value of acquiring company and target company pre acquisition should not be added to find Market Value post acquisition.

Earnings can be aggregated if there is no synergy.

If there is synergy Market Value Post acquisition

should be found as $\text{Earnings} \times \text{PE ratio}$

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Maximum Exchange ratio for A Co.,

$$ER_1 = \frac{-S_1}{S_2} + \frac{(E_1 + E_2) PE_{12}}{P_1 S_2}$$

Minimum Exchange Ratio for T Co.,

$$ER_2 = \frac{P_2 S_2}{(PE_{12})(E_1 + E_2) - P_1 S_2}$$

ER - exchange ratio

E - Earnings

S - Number of shares

PE - Price Earnings ratio

P - Price / share

1 - Acquiring Co.,

2 - Target Co.,

12 - Merged Co.,

Present Value of Annuity perpetuity - $\frac{A}{r}$

Present Value of growing perpetuity - $\frac{A}{r-g}$

Valuation

Liquidity ratio - how far my current liabilities are worth the current assets

Insolvency ratio - how far my longterm liabilities are worth the longterm asset

Activity ratio - Using some resource, managing resources, how efficiently I have used that asset.

$$\text{While Valuing an equity share} = \frac{D_1}{K_e - g}$$

$$\text{Earnings} = \frac{E}{K_e - g}$$

$$\text{FCFs} = \frac{\text{FCFF}_1}{K_e - g}$$

Value of the Company Using FCFs

$$V_0 = \frac{\text{FCFF}_1}{K_e - g}$$

Absolute Valuation Models:

1. Asset based approach - revenue generating
→ going concern Capital is ignored
→ Liquidation based
2. Earnings based approach
→ Capitalisation of earnings
→ Discounted future earnings

Relative Valuation Models:

Under this model, the value of the business is arrived by observing the MPS of similar companies - PE ratio.

Hedging

Money Market Hedge:

Foreign Currency payable:

1. Borrow Home Currency
2. Invest in foreign currency
3. Foreign currency deposit receivable will be used to pay original foreign currency payable (Future Value)
4. Consider foreign currency deposit rates (r_f)
5. Investment in foreign currency
$$PV = \frac{FV}{(1+r_f)}$$
6. Consider spot rate to find equivalent home currency borrowings
7. Convert and invest in foreign currency @ spot rate and invest.
8. Find Interest for home currency borrowings.
9. Repayment of home currency loan along with interest.

Foreign Currency Receivable:

1. Borrow in foreign currency, Invest in home currency
2. Original foreign currency receivable will be used to pay foreign currency borrowings (FV)
3. Consider foreign borrowing rate (r_f)
4. Borrowings in foreign currency $\frac{FV}{1+r_f}$
5. Exchange foreign currency into domestic currency at spot bid rate

6. Invest in domestic currency @ domestic deposit rate

7. After the period, find domestic investment receipts including interest

The interest rates are annual interest rate

∴ Interest rate for the relevant period must be taken.

The forward rate for a currency may be same / costlier / cheaper than its spot rate.

Currency costlier at a forward - premium
Currency cheaper at a forward - discount

forward disc / premium - can be expressed as annual %s of the difference between spot rate and forward rate

$$= \frac{\text{Forward} - \text{Spot}}{\text{Spot}} \times \frac{12}{n} \times 100$$

The difference between spot and forward may be expressed in terms of swap points.

Case 1: Swap points are low high

$$\text{forward rate} = \text{Spot} + \text{swappoints}$$

Case 2: Swap points are high low
forward rate = Spot - Swappoints.

Option:

An option is a special contract under which the option holder enjoys the right to buy/sell without the obligation to do so.

A call option gives the holder the right to buy.

A put option gives the holder the right to sell.

Situation	Call	Put
At the Money	Exercise price = Stock price	Exercise price = Stock price
In the Money	Exercise price < Stock price	Exercise price < Stock price
Out of Money	Exercise price > Stock price	Exercise price > Stock price

Relevant Cashflow:

'CUMULATIVE CONDITION'

Future Cashflow (+) changes with the alternative.

Relevance of option premium:

Situation 1:

Decision to be taken whether or not to purchase an option, the premium has not yet been paid.

It will be paid if option is bought. Therefore, it is relevant.

Situation 2:

Decision as to which option has to be bought the premium has not yet been paid. The premium to be paid for different exercise prices for different option is different.

It is relevant.

Situation 3:

Decision whether option to be exercised the company has already entered into the option contract & paid the premium upfront.

The premium amount does not change whether or not option is exercised. Therefore, the premium is relevant.

Intrinsic Value / Theoretical Value:

Value of option if exercised immediately.

So, for a call option = $\max(S - E \text{ or } 0)$

Put option = $\max(E - S \text{ or } 0)$

Intrinsic value can never be negative.

Extrinsic Value / Time Value:

Time value of the option is over & above the intrinsic value.

Call option = $\frac{\text{Call option premium}}{\text{premium}} - \text{Intrinsic Value}$

Put option = $\frac{\text{Put option premium}}{\text{premium}} - \text{Intrinsic Value}$

In both cases holder is going to pay.

Steps for Exchange traded currency option:

1. Consider whether foreign currency exposure is a payable/receivable.
2. Consider whether option contract is OTC/exchange traded.
3. Decide whether put option/call option is required.
4. Find currency requirement at option strike rate.
5. Consider contract size divide currency requirement by contract size to determine no. of option contracts.
6. The number of contracts cannot be fractional.
7. In the absence of information round up the contract to the higher number.
8. Find premium amount in domestic currency by applying spot rate.
9. Find cashflow after considering premium and balance amount.

Currency futures:

1. Consider whether foreign currency exposure is payable/receivable.
2. Consider the base currency.
3. Calculate currency requirement in contract currency units.
4. Divide by contract size to determine the no. of contracts.

5. Buy / sell future contracts as required.

Close the position after the period and find profit/loss (cash settlement)

6. Exchange original exposure in spot market

To adjust profit/loss from futures.

Dividend Decision

Walter Approach:

$$V_C = \frac{D + \frac{R}{k_e}(E-D)}{k_e} \quad R = \text{ROE}$$

Gordon Growth Model:

$$V_E = \left[\frac{D_0(1+g)}{k_e - g} \right]$$

Modigliani and Miller Hypothesis:

$$P_0 = \frac{P_1 + D_1}{1+k_e}$$

Dividend growth model:

$$P_0 = \frac{D_1}{k_e - g}$$

used to
compute
equilibrium
price

Dividend discount model:

with perpetual growth rate.

$$P_0 = \frac{Div_0(1+g_s)}{(1+k_e)^t} + \frac{Div_{n+1}}{k_e - g_n} \times \frac{1}{(1+k_e)^n}$$

Probable returns:

$\Rightarrow R\%$

$$R = \frac{D}{P_0} + \frac{P_1 - P_0}{P_0}$$

VALUE OF SHARE

1. EPS

(-) CapEx (1-b)	xx
(-) Working Cap (1-b)	x
(+) Depn (1-b)	x
	x
2. Equity investment / Share	xx

FCFE ① - ②

$$\text{Value / Share} = \frac{\text{FCFE}(1+g)}{K_e - g}$$

Free Cashflow:

Represents the cash that a company is able to generate after setting aside money required to maintain and expand its asset base.

Important because it allows the company to pursue opportunities that enhance shareholder value.

ARBITRAGE OPPORTUNITY:

- Find whether arbitrage is possible
 - find the theoretical forward rate using IRPT
 - compare actual forward rate and theoretical forward rate.

If they are equal, arbitrage is not possible, if not arbitrage is not possible.

2. Find Arbitrage gain

S₁: Actual forward rate > Theoretical forward rate
Borrow domestic, invest foreign.

S₂: Theoretical forward rate > Actual forward rate
Borrow foreign, invest domestic.