

**SVKM's NMIMS University
School of Distance Learning****Corporate Finance****Date: 17.12.2007
Time: 11.00 to 2.00****Marks: 100**

- I. Q. 1 is compulsory. Attempt any 4 questions from Q.2 to Q.6.
- II. All questions carry 20 marks.
- III. Make assumptions wherever necessary and state them with your answer.
- IV. Working notes must form part of your answers.
- V. Wherever there are sub-questions, answers to them must be together at the same place as the main question.

Q.1. A. Select answers from the choices given: (10 marks)

1. Which of the following is not a time-adjusted technique for evaluating investment decisions?
 - a. Net Present Value
 - b. Internal Rate of Return
 - c. Pay Back Period
 - d. Profitability Index
2. What is the cost of debt in case debentures are issued at a price other than the face value?
 - a. The internal rate of return which equates the issue price of the debentures with the present value of all coupon payments and maturity value
 - b. The coupon rate of interest
 - c. Coupon payments as a percentage of the issue price
 - d. None of the above
3. To calculate the economic value added (EVA), which measure of earnings do we use?
 - a. Net sales
 - b. Operating Profit
 - c. Profit before Taxes
 - d. Net Operating Profit after Taxes
4. The use of funds with fixed financial charges, in order to achieve a growth in EPS, higher than the growth in EBIT is called:
 - a. Capital budgeting
 - b. Operating leverage
 - c. Financial leverage
 - d. Arbitrage
5. According to the Net Operating Income approach, when leverage increases,
 - a. The WACC increases
 - b. The WACC reduces
 - c. The WACC increase up to a certain point and then gradually reduces
 - d. The WACC remains the same
6. According to the pecking order theory, which is the correct order of preferences financial managers have for raising funds ?
 - a. Equity, Debt and Retained earnings

- b. Retained earnings, Debt and Equity
 - c. Debt, Equity and Retained earnings
 - d. The theory states that financial managers have no fixed order of preference
7. According to the Graham-Dodd dividend model, the effect of an increase or decrease in dividends has a greater effect than an increase or decrease in retained earnings by how many times?
- a. They both have the same effect
 - b. Twice
 - c. Thrice
 - d. Four times
8. Under the SEBI (Substantial Acquisitions and Takeover Code) Regulations, a company has to make an open offer for acquiring shares in another company if the acquiring company's shareholding in the other company crosses,
- a. 5%
 - b. 15%
 - c. 20%
 - d. 25%
9. If the rate of return on a risk-free asset is 5.5% and the return on the market portfolio is 14%, what will be the cost of equity capital of a security whose beta is 1.2 ? Use the capital asset pricing model to determine the same.
- a. 10.2%
 - b. 9.75%
 - c. 8.5%
 - d. 5.5%
10. While evaluating a project, if the NPV method and the IRR method give different answers to the question of acceptance of the project then,
- a. You should always reject such projects
 - b. The results according to the NPV method must be considered
 - c. The results according to the IRR method must be considered
 - d. More calculations are required

Q.1. B. Proximal Instruments Ltd. paid a dividend of Rs.3 per share last year. The company's EPS is Rs.12 and its market multiplier is 1.5. According to the Graham-Dodd model, what will be the company's current share price? Also calculate the share price if the dividend per share is increased to Rs.4 while the EPS remains the same. (10 marks)

Q.2. Swaraj Engines Ltd. wants to buy a tooling machine, which will help it save costs of manufacturing its engines. The company has to make a choice between buying an imported German machine or an Indian machine. The German machine is of better quality and therefore has a life of 5 years while the Indian machine has a life of 4 years and none of them have any salvage value. The company's cost of capital is 12%.

Based on the estimated cost savings from both the engines given in the following table, which machine would you recommend that the company buy?

Use the NPV method for your evaluation.

	German machine (Rs.)	Indian machine (Rs.)
Initial investment	50,000	35,000

Total annual cost savings:		
Year 1	12,000	10,000
Year 2	13,000	11,000
Year 3	15,000	11,000
Year 4	12,000	10,000
Year 5	8,000	0

- Q.3. Skyscraper Constructions Ltd. has a capital structure comprising only of equity, made up of 10,000 shares of Rs.100 each. The company has a new construction project on hand for which it needs to raise additional funds of Rs.5,00,000.

The company has the following options to raise the funds:

- Option 1: Raise entire amount in form of equity shares of Rs.100 each.
 Option 2: Raise the entire amount in the form of 12% debentures.
 Option 3: Raise half the funds as equity shares of Rs.100 each and the other half as debentures paying 9% interest.
 Option 4: Raise half the funds as debt paying 9% interest and the other half as preference shares paying 13% interest

The company's current EBIT is Rs.1,80,000 and the new project will add Rs.90,000 to the EBIT.

You are requested to evaluate the best option from the 4 listed above which the company must choose. Assume the tax rate to be 40%.

- Q.4. The following data is available about a project which involves an initial investment of Rs.75,000 and has a life of 6 years.

The project starts yielding returns only from the 2nd year onwards, which are tabulated below.

Year	Annual after tax cash flows (Rs.)
1	15,000
2	18,000
3	22,000
4	28,000
5	25,000
6	15,000

Calculate the internal rate of return of the project. Also advice if you would accept or reject the project, if the company's cost of capital is 14%.

- Q.5. Heavy-duty Cement Ltd. Has appointed you to compute its weighted average cost of capital. The company's total capital is Rs.15,00,000, comprising of 10,000 equity shares of Rs.100 each and 50,000 debentures of Rs.10 each.

The debentures carry a coupon rate of 11% payable annually. They have been issued for a period of 4 years and on maturity, Rs.90 per debenture will be repaid.

The beta of the company's shares is 1.25 and the required rate of return on the market portfolio is 15% while the risk-free rate is 8%.

Using the above information, compute Heavy-duty Cement's cost of debt (k_d), cost of equity (k_e) and WACC.

Q.6. Write short notes on any FOUR (5 marks each)

- a) Differences between NPV and IRR
- b) Cash flows vs. Accounting Profits
- c) Economic Value Added
- d) Pecking order of finance
- e) Financial leverage
- f) Share buyback