

SVKM's NMIMS University
School of Distance Learning

Capital Investment & Financing Decisions

Date: 22.12.2007
Time: 11.00 to 2.00

Marks: 100

Instructions:

1. Answer any FIVE of the following questions
2. All the questions carry equal marks
3. Neatness and proper presentation will be rewarded.
4. Answer to each question to be started on a fresh page

Question 1

(20 marks)

Two projects being considered are mutually exclusive and have the following projected cash flows:

Year	Project A-Cash Flows	Project B-Cash flows
0	-50000	-50000
1	15625	0
2	15625	0
3	15625	0
4	15625	0
5	15625	99500

If the required rate of return on these projects is 10 per cent, which would be chosen using PI criterion and critically comment?

OR

Explain briefly various methods of Capital Budgeting techniques and their pros and cons with suitable examples and

Question 2

(20 marks)

What do you understand about Mergers & Acquisitions? Briefly explain about leveraged buy out? How is it different from other methods of buy outs.

OR

Following are the details regarding three companies A Ltd, B Ltd and C Ltd.

	A Ltd	B Ltd	C Ltd
Internal rate of return (percent)	15	5	10
Cost of equity capital (percent)	10	10	10
EPS (Rs)	8	8	8

Calculate the value of an equity share of each of these companies using Walter's model when D/P ratio is (i) 50 per cent, (ii) 75 per cent and (iii) 25 per cent. What conclusions do you draw?

Question 3

(20 marks)

Answer the following Multiple Choice Questions (3×5=15 Marks)

1. Under which of the following approaches cost of equity capital is assumed to be constant with the changes in leverage?
 - a. Net Income Approach
 - b. Net Operating Income Approach
 - c. Modigliani and Miller Approach
 - d. Both (a) and (c) above
 - e. Both (b) and (c) above

2. If the interest rate on long-term debt is 18% p.a. and the tax rate of the company is 35%, the cost of debt is
 - a. 10.70%
 - b. 11.70%
 - c. 12.85%
 - d. 12.70%
 - e. 13.00%

3. If the required rate of return on Excel Ltd.'s shares is 16%, risk-free rate of return is 8%, and the rate of return on market portfolio is 11%, what is the 'beta' of the stock?

a. 1.67	b. 2.67
c. 0.38	d. 2.87
e. 1.00	

4. Agency cost arises to
 - a. cost overrun in implementing new projects
 - b. failure of budgeted cost
 - c. restrictions imposed by the supplier of debt capital
 - d. rise in the cost of production
 - e. None of the above

5. The overall capitalization rate and the cost of debt remain constant for all degrees of leverage. This is pronounced by

- a. Traditional Approach
- b. Miller and Modigliani Approach
- c. Net Operating Income Approach
- d. Net Income Approach
- e. Both (c) and (d) above

6. A company pays a constant dividend @ 20% p.a. Its EPS is Rs. 5 and Price Earning Ratio is 12. It is expected that its dividends will grow @ 5% p.a. Find out its cost of equity applying dividend growth mode. Face Value is Rs. 10. (5 Marks)

OR

What do you understand about Time Value of Money and explain in detail with suitable example. Why is Time Value of Money independent of inflation and risk. Differentiate Present Value and Terminal Value.

Question 4

(20 marks)

A company is considering the possibility of raising by issuing debt, preference capital, equity and retaining earnings. The book values and the market values of the issues are as follows

Source of Capital	Book Values	Market Values
Equity Shares	300000	600000
Reserves	100000	Nil
Preference Shares	200000	240000
Debt	400000	360000
TOTAL	1000000	1200000

The following costs are associated with the above mentioned issues of capital. Assume 35% as a tax rate.

- a. The cost of debt is 16%
- b. The cost of preference dividends is 11%

The firm's equity share is currently selling for Rs. 150. It is expected that the firm will pay a dividend of Rs. 12 per share at the end of the next year which expected to grow at a rate of 7 percent. Compute cost of equity?

OR

What are the characteristics of capital market? How is it different from money market? Briefly write about Indian Capital markets?

Question 5**(20 marks)**

- 1a. Bring out the meaning and significance of Financial Leverage
- 1b. From the following calculate the degree of operating leverage, degree of financial leverage and combined leverage for the following firms and interpret the result

	P	Q	R
Output (units)	300000	75000	500000
Fixed Cost (Rs.)	350000	700000	75000
Unit Variable Cost (Rs.)	1	7.5	0.1
Interest Expenses	25000	40000	NILL
Unit Selling Price	3	25	0.5

OR

Answer any FOUR of the following questions

1. Explain in brief what you understand about CAPM and the value of Beta.
2. Why cost of debt is cheaper than other source of capital? Explain briefly.
3. Compute the cost of equity based on CAPM if Risk free rate of return is 4.5%. The beta of the script is 1.1. The market return over the Nifty 50 is 12%.
4. PVR company earns Rs.10 per share at an internal rate of return of 15%. The Firm has a policy of paying 40% of earnings as dividends. If the required rate of return is 10%, Determine the price of the share based on Walter's Model.
5. List out various types of Capital Budgeting Techniques used for evaluation of investment decisions under uncertainty.
6. Define Finance Leverage. What do you mean by Levered firm and Unlevered Firm?
7. Assume 7 percent debentures of face value of 100 and corporate tax is 30%, Calculate the effective cost of debt? What will be effective cost of debt if the debentures are quoted at Rs.98 in the market?