STELLA MARIS COLLEGE (AUTONOMOUS) CHENNAI – 600 086.
(For candidates admitted during the academic year 2008-2009 & thereafter)

SUBJECT CODE: CM/MC/CF54

B.Com. DEGREE EXAMINATION NOVEMBER 2012
COMMERCE
FIFTH SEMESTER

COURSE	**:**	**MAJOR CORE**	
PAPER	**:**	**CORPORATE FINANCE**	
TIME	**:**	**3 HOURS**	**MAX. MARKS : 100**

SECTION – A
ANSWER ALL QUESTIONS **(30 X 1 = 30)**

I. Fill in the blanks :

1. Optimum leverage can be defined as that mix of debt and equity which will ___________ the market value of the firm.
2. ___________ is the process of allocating the funds to most desirable projects due to limitations on the availability of financing.
3. The time gap between the sales and their actual realization in cash is known as ___________.
4. ___________ involves mergers and acquisitions of firms belonging to different countries of the world.
5. The most appropriate dividend policy is payment of ____________.
6. The cost of capital comprises both business and __________risks.
7. The length of the time needed to regain the original investment under capital budgeting is termed as ___________.
8. ___________ refers to firm's investment in total current or circulating assets.
9. ___________ is the joining of two or more companies in the same line of business.
10. The policy concerning quantum of profits to be distributed as dividend is termed as ___________.

II. State whether the following statements are TRUE or FALSE

11. The ideal situation is to have a high financial leverage and low operating leverage.
12. Pay-back method takes into account the cash flows after the pay-back period.
13. A large balance of cash in hand should be kept by a firm to meet all contingencies.
14. Take-over is an external method of expansion.
15. Shareholders generally prefer 'capital gains' to current dividends.
16. Retained earnings have no cost to the firm.
17. Discounted cash flow techniques takes into account the time value of money.
18. A firm cannot have a strict credit policy in case its products are in demand.
19. The 'amalgamation' and 'merger' are technically synonymous.
20. Walter's model is based on the relationship between 'r' and 'k'.

III. Choose the correct answer from the following:

21. It refers to that EBIT level at which EPS remains the same irrespective of the debt-equity mix
    a) Trading on Equity b) Optimum capital structure
    c) Point of indifference d) None of the alternatives

22. The minimum rate of return a firm must earn on its investments to maintain the market value of its equity shares
    a) Average cost of capital b) Cost of capital
    c) Explicit cost of capital d) None of the alternatives

23. While evaluating capital investment proposals, the time value of money is considered in case of
    a) Pay-back method b) Discounted cash flow method
    c) Accounting rate of return method d) Internal rate of return method

24. This refers to such working capital which keeps on fluctuating from time to time on the basis of business activities
    a) Gross working capital b) Net working capital
    c) Temporary working capital d) Permanent working capital

25. According to the MRTP Act, 'takeover' involves acquisition of not less than
    a) 50% of the voting power in a body corporate
    b) 25% of voting power in a body corporate
    c) 10% of the voting power in a body corporate
    d) None of the alternatives

26. The tendency of the residual net income to vary disproportionately with operating profit is termed as
    a) Financial leverage b) Operating leverage
    c) Composite leverage d) None of the alternatives

27. The return after the pay-off period is not considered in case of
    a) Pay-back method b) Internal rate of return method
    c) Present value Index method d) Discounted cash flow method

28. __________ refers to the time duration for which credit is extended to the customer is
    a) credit policy b) credit terms
    c) credit period d) None of the alternatives

29. For takeover of a company section 395 of the Companies Act provides an alternative without
    a) Going the Court b) Approaching the share holders
    c) Central Government d) None of the Alternatives

30. According to _____________ approach, dividend policy has no effect on the share price of a company.
    a) Walter approach b) M.M. approach
    c) Gordon approach d) None of the Alternatives

SECTION – B

ANSWER ANY FIVE QUESTIONS **(5 X 8 = 40)**

31. Explain the principle motives for holding cash.

32. What are the different steps to be taken for effecting Merger?

33. The Capital structure of the progressive corporation consists of an ordinary share capital of Rs. 10,00,000 (Shares of Rs.100 per value) and Rs. 10,00,000 of 10% debentures. Sales increased by 20% from 1,00,000 units to 1,20,000 units, the selling price is Rs. 10 per unit. Variable cost amounts to Rs. 6 per unit and fixed expenses amounts to Rs. 2,00,000. The income tax rate is assumed to be 50%.
You are required to calculate the following:
    i) The Earnings per share (EPS) and % increase in EPS.
    ii) The Financial leverage at 1,00,000 units and 1,20,000 units.
    iii) The Operating leverage at 1,00,000 units and 1,20,000 units.
    iv) The combine leverage at 1,00,000 units and 1,20,000 units.

Comment on the leverage behaviour.

34. The Alpha company ltd. is considering the purchase of a new machine. Two alternative machines (A and B) have been suggested each having an initial cost of Rs. 4,00,000 and requiring Rs.20,000 as additional working capital. Earnings after taxation are expected to be as follows:

Year	**1**	**2**	**3**	**4**	**5**
Machine A Cash in flows	Rs.40,000	Rs.1,20,000	Rs.1,60,000	Rs.2,40,000	Rs.1,60,000
Machine B Cash in flows	Rs.1,20,000	Rs.1,60,000	Rs.2,00,000	Rs.1,20,000	Rs.80,000

The company has target of return on capital of 10% and on this basis, you are required to compare the profitability of the machines and state which alternative you consider financially preferable under NPV method.

Note: The following table gives the present value of Re 1.00 due in 'n' number of years.

Year	**1**	**2**	**3**	**4**	**5**
Present value at 10%	0.91	0.83	0.75	0.86	0.62

35. From the following information prepare a statement in columnar form showing the working capital requirements.

(i) in total, and (ii) as regards each constituent part of working capital.

Budgeted Sales (Rs.10 per unit) Rs. 2,60,000 per annum

Analysis of one rupee of sales:

Raw materials	0.30
Direct labour	0.40
Overheads	0.20
Total cost	0.90
Profit	0.10
Sales	1.00

It is estimated that:-

(i) Raw materials are carried in stock for three weeks and finished goods for two weeks.

(ii) Factory processing will take three weeks.

(iii) Suppliers will give full five weeks credit.

(iv) Customers will require eight weeks credit.

It may be assumed that production and overheads accrue evenly throught the year.

36. Firm A is planning to acquire firm B. The relevant financial details of the two firms prior to merger announcement are as follows:

	Firm A	**Firm B**
Market price per share (Rs.)	75	30
Number of shares	10,00,000	5,00,000
Market value of the firm (Rs.)	7,50,000	1,50,00,000

The merger is expected to bring gains which have a present value of Rs. 1,50,00,000. Firm A offers 2,50,000 shares in exchange for 5,00,000 shares to the shareholders of firm B. You are required to calculate (i) True cost of firm A for acquiring firm 'B' and (ii) Net present value of the merger to firms A and B.

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

A Ltd	**B Ltd**	**C Ltd**
r = 15%	r = 5%	r = 10%
Ke = 10%	Ke = 10%	Ke = 10%
E = Rs. 8	E = Rs. 8	E = Rs. 8

Calculate the value of an equity share of each of these companies applying walter's formula when dividend payout ratio is (a) 50% (b) 75% (c) 25%

SECTION – C

ANSWER ALL QUESTIONS (30 MARKS)

38. Suman Joshi, Managing director of Omega Textiles, was reviewing two very different investment proposals. The first one is for expanding the capacity in the main line of business and the second one is for diversifying into a new line of business.

Suman Joshi asks for your help in estimating Omega's weighted average cost of capital which he believes is relevant for evaluating the expansion proposal. He also wants you to estimate the hurdle rate for the new line of business.

To enable you to carry out your task, he has provided the following data.

- The latest balance sheet of Omega is given below.

Rs. in million

Liabilities		**Assets**	
Equity capital	350	Fixed assets	700
Preference capital	100	Investments	100
Reserves and surplus	200	Current assets, loans and advances	400
Debentures	450		
Current liabilities & provisions	200		
	1200		1200

- Omega's target capital structure has 50 percent equity, 10 percent preferences, and 40 percent debt.
- Omega has Rs. 100 par, 10 percent coupon, annual payment, noncallable debentures with 8 years to maturity. These debentures are selling currently at Rs. 112.
- Omega has Rs. 100 par, 9 percent, annual dividend, preference shares with a residual maturity of 5 years. The market price of these preference shares is Rs. 106.
- Omega's equity stock is currently selling at Rs. 80 per share. Its last dividend was Rs. 2.80 and the dividend per share is expected to grow at a rate of 10 percent in future.
- Omega's equity beta is 1.1, the risk-free rate is 7 percent, and the market risk premium is estimated to be 7 percent.
- Omega's tax rate is 30 percent.
- The new business that Omega is considering has different financial characteristics the Omega's existing business. Firms engaged purely in such business have, on average, the following characteristics: (i) their capital structure has dept and equity in equal proportions (ii) their cost of debt is 11 percent (iii) their equity beta is 1.5.
  a) What sources of capital would you consider relevant for calculating the weighted average cost of capital?
  b) What is Omega's post-tax cost of debt?
  c) What is Omega's cost of preference?
  d) What is Omega's estimated cost of equity using the dividend growth model?
  e) What is Omega's weighted average cost of capital? Use the capital asset pricing model to estimate the cost of equity.
  f) What would be your estimate for the cost of capital for the new business?