Major Test (May, 2016)
SML 870: Advanced Financial Management

Time: 2 Hours *Maximum Marks: 35*

Note: **Attempt any 3 questions from questions 1 to 4. Question 5 is compulsory.** You will be allowed to make use of present value tables.

Q1.(a). Sound Limited is contemplating taking over the business of Target Limited. The summarized balance sheet of Target Limited as on 31st March, current year, was as follows:

(Rs lakh)

Liabilities	Amount	Assets	Amount
Equity share capital (50 lakh @ Rs 10)	500	Fixed assets:	
General reserve	250	Land and buildings	200 500
Profit and loss account	120	Investments	100
13% Debentures	100	Plant and machinery	580 500
Current liabilities	30	Current assets:	
		Inventories	70
		Debtors	35
		Bank	15
	1,000		1,000

+75

-95

Additional Information:

1. Sound Limited agrees to take over all the current assets and investments of Target limited at their book values but the other fixed assets were to be revalued as under:
   Land and buildings: Rs 500 lakh
   Plant and machinery: Rs 500 lakh
   These sums apart, Sound Limited is required to pay Rs 75 lakh for goodwill.
   Pending court disputes are likely to be settled for Rs. 70 lakh
   After acquisition, the investments are to be disposed of; they are expected to realize Rs. 95 lakh.

2. Purchase consideration is to be paid as Rs 130 lakh, in cash, to pay for 13% debentures and other liabilities, and the balance is to be paid in terms of shares of Sound Limited.

3. Expected benefits (FCFF) accruing to Sound Limited are as follows:

Year 1	Year 2	Year 3	Year 4	Year 5
Rs 200	Rs 300	Rs 260	Rs 200	Rs 100

   Further, it is estimated that the FCFF are expected to decline at 5 per cent per annum after 5 years.

4. Cost of liquidation is expected to be Rs. 20 lakh.
5. Cost of capital for the purpose of analysis is to be 14 per cent.

Suggest whether Sound Limited is likely to benefit from taking over of Target Limited. **(7)**

b). Define (i) horizontal mergers,(ii) vertical mergers and (iii) conglomerate mergers? What synergies do exist in each of these? **(3)**

OR

From the following condensed income statement of a corporate for the current year, determine the EVA added during the year:

(Amount in Rs crore)

Sales revenue	200
*Less:*Operating expenses	120
*Less:*Interest (on Rs 200 crore)	20
Earnings before taxes	60
Less: Taxes (30%)	18
Earnings after taxes	42

Firm's cost of equity capital is 15 per cent (equity funds, Rs 150 crore). Firm has 12 per cent preference share capital of Rs 50 crore. Ignore dividend payment tax. **(3)**

Q2. Attempt ***any two*** of the following questions:

(a). Arvind Ltd. belongs to a risk-class for which the appropriate equity capitalization rate is 10 per cent. It currently has outstanding 25,000 shares selling at Rs 100 each. The firm is contemplating the declaration of dividend of Rs 5 per share at the end of the current financial year. The company expects to have a net income of Rs. 2.5 lakh and has a proposal for making new investments of Rs 5 lakh.

Show that under the MM assumptions, the payment of dividend does not affect the value of the firm. **(5)**

(b). Stable dividend policy has a price-enhancing effect. Elucidate the statement with the help of theoretical factors as well as empirical work (Lintner's model) on the subject. **(5)**

(c). The following figures are collected from the current year annual report of ABC Ltd.

Earnings of firm (for equity-holders)	Rs 36 lakh
Number of equity shares	6 lakh
Return on investment	22.5 %
Cost of equity	15%

Determine the optimum dividend payout ratio according to Walter. Determine the market price of share at optimum dividend payout ratio. What will be the minimum and maximum price under the Walter's model? **(5)**

Q3. Attempt ***any two*** of the following:

(a). Explain the following concepts with the help of appropriate examples: (i) book value, (ii) market value, (iii) intrinsic value, (iv) liquidation value and (v) fair value. **(5)**

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(b). The finance advisor of A-star Ltd is confronted with two alternative financing plans for raising Rs 20 lakh that is needed for plant expansion and modernization. One choice is 12% Debt issue. The other is to issue 16,000 equity shares at the current market price per share of Rs 125.

Balance sheet as on March 31, current year

Liabilities	Amount	Assets	Amount
Current liabilities	Rs 10,00,000	Current assets	Rs 32,00,000
10% Long-term loan	30,00,000	Plant and equipment	
Reserves and surpluses	20,00,000	(net)	68,00,000
Equity capital (shares of Rs 100 each)	40,00,000		
	100,00,000		100,00,000

Income statement for the current year

Operating profits	Rs 16,00,000
Less interest expenses	3,00,000
Income before taxes	13,00,000
Less taxes (0.35)	4,55,000
Net income	8,45,000
Earnings per share	21.125

However, the finance advisor is concerned about the effect that issuing debt might have on the firm. The average long-term debt to assets ratio for firms in industry is 32 per cent. He believes that if this ratio is exceeded, the P/E ratio will fall to 5 because of the potentially greater risk. If the firm increases its equity capital, he expects the P/E ratio to increase to 6.5. The expansion and modernization program is expected to increase operating profits by 25 per cent.

Which form of financing should be employed by the company, if the company follows a policy of maximizing market value of its shares? **(5)**

(c). The following information is related to the acquiring firm A Ltd. and the target firm T Ltd.

Particulars	**Firm A**	**Firm T**
EAT (Rs lakh)	1,000	200
Number of shares outstanding (in lakh)	100	50
EPS (Rs)	10	4
P/E ratio (times)	10	5
MPS (Rs)	100	20

(i) What is the share exchange ratio based on current market prices?
What is the EPS of A Ltd after acquisition?
What is the expected market price per share (MPS) of A Ltd after acquisition, assuming P/E ratio of Firm A remains unchanged.
Determine the market value of the merged firm.
Calculate total gain from acquisition.

(ii) Determine the share exchange ratio when all gains from merger are to accrue to Firm T. **(5)**

Q4. Write short notes on ***any two*** of the following:

(a). Gordon Donaldson's approach on the risk of bankruptcy in the context of designing capital structure.

(b). Bonus shares and share splits

(c). Gordon's model related to dividend payments.

(d). Financial restructuring **(10)**