# GUJARAT NATIONAL LAW UNIVERSITY
# GANDHINAGAR

Course: **Financial Management**

**Semester-V (Batch: 2012-17)**



## End Term Examination: Oct-Nov. 2014

**Date: 1st November, 2014**
**Duration: 3 hours** **Max. Marks: 50**

**Instructions:**

- Read the questions properly and write the answers in the given answer book.
- The respective marks for each question are indicated in-line.
- Do not write anything on the question paper.
- Indicate correct question numbers in front of the answers.
- No questions or clarifications can be sought during the exam period, answer as it is, giving reason, if any.
- **Use of scientific calculator and mathematical table is permitted.**

**Answer any five questions** **Marks**

Q.1 A firm presently has Rs.1,00,000 of market value as well as fixed capital requirement. It is currently fully financed by equity. The cost of equity is 12%. However, it is interested to use debt as the prevailing market conditions are favourable. The firm is interested to try combinations of 20%, 50% and 80% debt and remaining equity respectively. The cost of debt is 10%. Examine the value of the firm under Net Income (NI) Approach and Net Operating Income (NOI) Approach. (10)

In the same firm, the following changes are expected in the cost of equity and cost of debt as a response to change in debt equity ratio.

| Debt/Equity Ratio | Current Cost of Equity ($k_e$) | Expected Cost of Equity ($k_e$) | Current Cost of Debt ($k_d$) | Expected Cost of Debt ($k_d$) |
|---|---|---|---|---|
| **0/100** | 12% | 12% | 10% | 10% |
| **20/80** | 12% | 12% | 10% | 10% |
| **50/50** | 12% | 15% | 10% | 12% |
| **80/20** | 12% | 18% | 10% | 14% |
| **100/0** | 12% | 20% | 10% | 16% |

Examine the value of the firm under the traditional approach for combinations of debt and equity of 50/50, 80/20 and 100/0.

Q.2 a. Francis Ltd. wants to maintain a minimum cash balance of Rs.2,00,000. The estimated standard deviation of the daily cash flows is Rs.1,200. The cost for each transaction of buying and selling marketable securities is fixed at Rs.100. The daily interest rate on marketable securities is 0.1% or (.001). (5+5=10)

Using the Miller-Orr model of cash management, formulate the company's cash management policy.

b. A company issued 12% debentures of Rs.1,00,000, redeemable at the end of 5 years. The debentures were issued at 10% premium and will be redeemed at 20% premium. The company incurred expenses of Rs.10,000 for obtaining credit rating and

Rs.5,000 for legal advice at the time of issue.

Determine the Cost of Debt ($k_d$), if tax rate prevalent is 30%.

Q.3 Altis Ltd. has reported an Earning per Share (EPS) of Rs.20 which is likely to remain constant for over a year. Its cost of equity capital ($k_e$) will also remain constant at 10% over the year. (10)

Find out the market price of the share of Altis Ltd. under different rates of return (r), of 10%, 15% and 20%, and different payout ratios of 0%, 40% and 100% under both Walter's model and Gordon's model of dividend relevance.

Q.4 A firm is evaluating an investment proposal with an initial investment of Rs.2,00,000. (10)

It is expected to generate the following cash inflows at the end of each year for next 5 years.

| Year | Cash Inflow |
|---|---|
| 1 | Rs.60,000 |
| 2 | Rs.70,000 |
| 3 | Rs.85,000 |
| 4 | Rs.50,000 |
| 5 | Rs.80,000 |

Determine the **Internal Rate of Return** (IRR) of the Proposal. Applying the IRR you have determined as the discount rate, show that the Net Present Value (NPV) of the proposal at IRR is Zero if cash inflows are discounted at the IRR.

Recommend whether the project should be accepted, if the Cost of Capital (WACC) of the company is 10%. Also, find out the sensitivity of the Initial Investment and Discount Rate with respect to Net Present Value of the project.

(Note: The use of payback method is simply to find a starting point for trial and error)

Q.5 a. The share capital of a company is Rs.10,00,000 with shares of face value of Rs.10. It has Debt capital bearing interest rate of 10% of Rs.6,00,000. The sales of the firm is 3,00,000 units per annum at a selling price of Rs.5 per unit and variable cost of Rs.3 per unit. The annual fixed operating costs amount to Rs.2,00,000. The company pays tax at the rate of 30%. If the sales is expected to increase by 20%, determine the following; (5+5=10)

i. Percentage increase in Earning per Share (EPS)

ii. Combined Leverage at both the existing and expected level of sales

b. Differentiate between the objectives of the firm of Profit, Wealth and Value maximization.

Q.6 Discuss both propositions of Modigliani and Miller (MM) approach of irrelevance of capital structure. (10)

Q.7 a. Explain conservative and aggressive approaches to working capital policy. Elaborate on various sources of working capital finance available to companies. (06)

b. Write short notes on **any two** of the following. (2x2=04)

i. Capital Asset Pricing Model (CAPM)

ii. Operating Cycle

iii. Risk Adjusted Discount Rate (RADR)

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