**Strategic financial management**

**Dec 2020**

**1. The following is the capital structure of Alpha Limited as on 31st March 2020**

**Equity Shares: 10000 shares (of Rs 100 each) Rs 10,00,000**

**12% Preference Shares (of Rs 100 each) Rs 10,00,000**

**10% Debentures Rs 12,00,000**

**The market price of the company’s share is Rs 120 and it is expected that a dividend of Rs 10 per share would be declared by the company. The dividend growth rate is 5%. If the tax rate is 30%, calculate Weighted Average Cost of Capital (WACC) by book value & market value method. Assume market value of Preference shares and Debentures to be same as the book value. Comment on the results.**

**Answer**: **Computation of WACC on the basis of book value weights**

|  |  |  |  |
| --- | --- | --- | --- |
| **Source** | **Weight(W)\*** | **C/C** | **W \* C/C** |
| Equity shares | 0.31 | 15 | 4.65 |
| 12% Preference shares | 0.31 | 12 | 3.72 |
| 10% Debentures | 0.38 | 7 | 2.66 |
| **Weighted Average Cost of Capital** | **11.03** |

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**2. The following details are available for Gamma Ltd:**

|  |  |  |
| --- | --- | --- |
| **Details** | **Proposal A** | **Proposal B** |
| **Initial Cost** | **Rs.10,00,000** | **Rs. 12,00,000** |
| **Expected life** | **4 years** | **5 years** |
| **Profits before****tax after depreciation** | **Rs. 3,00,000 each for first two years****Rs. 3,50,000 each for next two years** | **Rs. 3,00,000 each for first two years****Rs. 3,50,000 each for next three years** |

**Calculate Discounted Payback period and suggest which one is better if the discounting factor is 10% and tax rate 30%. Show in detail relevant calculations and use Straight Line Method of Depreciation.**

**Answer**: Payback period is defined as the length of time required to recover the initial cash out lay. Discounted payback period is more reliable than simple payback period since it accounts for time value of money. It is interesting to note that if a project has negative net present value it won't pay back

**3. A company’s current earnings before interest and taxes are Rs 5,00,000. The firm currently has outstanding Rs 10 lakh of debts at an average cost of 8 per cent. Its cost of equity capital is estimated to equal 12 per cent.**

**a. Determine the current value and overall capitalisation rate of the firm using the Net Income Approach. Comment on the impact of increase in debentures on the value of the firm as per Net Income Approach.**

**b. The firm is considering reducing its debt by Rs 5 lakhs. The cost of debt and EBIT is expected to be unaffected. However, the firm’s cost of equity capital is to be reduced to 10 per cent due to decrease in financial risk. Would you recommend the proposed action (Based on value of firm and overall cost of capital)? Show relevant calculations using Net Income Approach.**

**Answer**: a) **Current value and overall capitalisation rate of the firm using the Net Income Approach**

|  |  |
| --- | --- |
| **Particulars** | **Amount (Rs.)** |
| Net operating income (EBIT) | 500000 |
| **Less**: Interest on debentures (8% of 1000000) | 80000 |
| Earnings for shareholders (A) | 420000 |
| Equity capitalisation rate (B) | 0.12 |
| Market value of Equity (A/B) | 3500000 |
| Market value of Debt | 1000000 |
| Total value of Firm (V) | 4500000 |
| Overall Capitalisation rate (EBIT/V) | 11.11% |

**Impact of increase in debentures on the value of the firm**: If there is an increase in debentures, the cost