

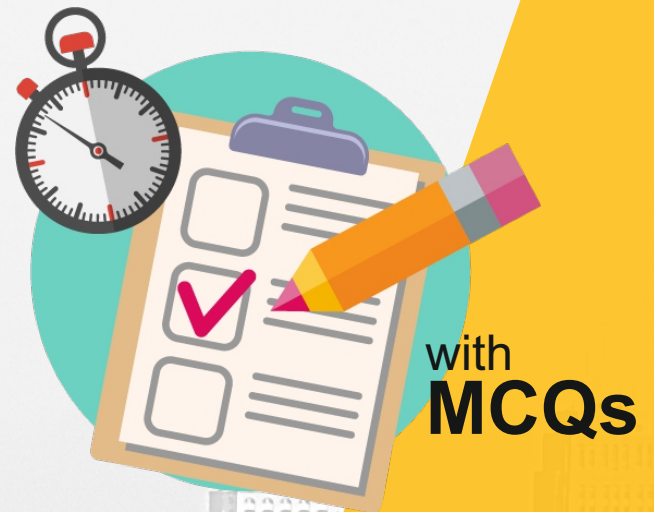
CA Final

Advanced Financial Management

OUTSCANNER

QUESTION BANK WITH AUDIO SOLUTION

Relevant for May 24 & onwards...



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Meet Adish

Chartered Accountant (CA) & Chartered Financial Analyst (CFA)

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Teaches CA Final-AFM, CFA and Financial Modelling

Taught 4000+ students across courses

His 2 core mantra for students:

- Conceptual Clarity
- Comprehensive Coverage



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Hey! Let's connect here...



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2 Amazing Features

Changing student's experience...

SCANNABLE COMPILER

$$\sigma_p^2 = (\sigma_A \omega_A)^2 + (\sigma_B \omega_B)^2 + 2\sigma_A \omega_A \sigma_B \omega_B r_{AB}$$

$$\sigma_p^2 = (\sigma_A \omega_A)^2 + (\sigma_B \omega_B)^2 + 2\omega_A \omega_B \text{Cov}_{AB}$$

In case of 3 securities in the portfolio:

$$\sigma_p^2 = (\sigma_A \omega_A)^2 + (\sigma_B \omega_B)^2 + (\sigma_C \omega_C)^2 + 2\omega_A \omega_B \text{Cov}_{AB} + 2\omega_B \omega_C \text{Cov}_{BC} + 2\omega_A \omega_C \text{Cov}_{AC}$$

Special Case of σ of two securities, when r is equal to +1 and -1

Perfect Negative $r = -1$ No Correlation $r = 0$ Perfect Positive $r = +1$

negative corr. positive corr.

If we put $r = +1$ and -1 in the below formula of SD:

$$\sigma_p = \sqrt{(\sigma_A \omega_A)^2 + (\sigma_B \omega_B)^2 + 2\sigma_A \omega_A \sigma_B \omega_B r_{AB}}$$

$\sigma_p = \sigma_A \omega_A - \sigma_B \omega_B$ $\sigma_p = \sigma_A \omega_A + \sigma_B \omega_B$

$E(R_p) = E(R_A) \times \omega_A + E(R_B) \times \omega_B$

QUESTION 6:
RTP N 20

Mr. SG sold five 4-Month Nifty Futures on 1st February 2020 for ₹ 9,00,000. At the time of closing of trading on the last Thursday of May 2020 (expiry), Index turned out to be 2100. The contract multiplier is 75.

Based on the above information calculate:

- The price of one Future Contract on 1st February 2020.
- Approximate Nifty Sensex on 1st February 2020 if the Price of Future Contract on same date was theoretically correct. On the same day Risk Free Rate of Interest and Dividend Yield on Index was 9% and 6% p.a. respectively.
- The maximum Contango/Backwardation.
- The pay-off of the transaction.

Note: Carry out calculation on month basis.

Solution:

- Price of one future contract on 1st Feb, 2020

$$= \frac{900000}{5}$$

$$= ₹ 180000$$
- Calculation of Nifty Index Spot Price:

$$FP = SP \times [1 + (r - y) \times n] \times 75$$

$$180000 = SP \times [1 + (0.09 - 0.06) \times 4/12] \times 75$$

$$178218 = SP \times 75$$

$$2376.23 = SP$$
- Maximum contango/Backwardation
 spot = 2376.23
 future = 2400 (180000/75)
 $S < F$
 $2376.23 < 2400$ ∴ market is in contango
 Max. contango = Basis
 $= S - F$

Audio Solutions

UNIQUE STRUCTURED CONCEPT NOTES

CA Final
Strategic Financial Management

OUTNOTES
UNIQUE STRUCTURED CONCEPT NOTES
ALONG WITH THEORY NOTES
Relevant for Nov- 23 & onwards...

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THEORY NOTES
Relevant for Nov 23

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FAST
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New Questions by ICAI
Relevant for Nov 23
All new questions from Exam Paper, RTPs and MTPs of Nov 21 to May 23

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OutNotes vs. ICAI Chapters

No.	ICAI Chapter Name	OutNotes Chapter Name
1	Financial Policy and Corporate Strategy	Financial Policy and Corporate Strategy
2	Risk Management	Risk Management & Security Analysis
4	Security Analysis	
3	Advanced Capital Budgeting Decisions	Advanced Capital Budgeting Decisions
5	Security Valuation	Fixed Income Securities
	Preference Share Valuation	
	Bond Valuation	
	Money Market Securities	
	Equity Valuation	Equity & Business Valuation
13	Business Valuation	
6	Portfolio Management	Portfolio Management
7	Securitization	Securitization
8	Mutual Funds	Mutual Funds
9	Derivatives Analysis and Valuation	Derivatives & Interest Rate Risk Management
12	Interest Rate Risk Management	
10	Foreign Exchange Exposure and Risk Management	Foreign Exchange & International Financial Management
11	International Financial Management	
14	Mergers, Acquisitions and Corporate Restructuring	Mergers, Acquisitions and Corporate Restructuring
15	Startup Finance	Startup Finance

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Equity & Business Valuation



A. Dividend based Valuation Models



QUESTION 1:

N 10 | N 08

Amal Ltd. has been maintaining a growth rate of 12% in dividends. The company has paid dividend @ ₹3 per share. The rate of return on market portfolio is 15% and the risk-free rate of return in the market has been observed as 10%. The beta co-efficient of the company's share is 1.2.

You are required to calculate the expected rate of return on the company's shares as per CAPM model and the equilibrium price per share by dividend growth model.

Solution:

As per CAPM:

$$\begin{aligned} E_R &= R_f + \beta (R_m - R_f) \\ &= 10 + [1.2 (15 - 10)] \\ &= 16\% \text{ or } 0.16 \end{aligned}$$

Applying dividend growth mode for the calculation of equilibrium price:-

$$\begin{aligned} P_0 &= \frac{D_1}{K_e - g} \\ &= \frac{3(1.12)}{0.16 - 0.12} \\ &= ₹84 \end{aligned}$$

Therefore, equilibrium price per share will be ₹ 84.



QUESTION 2:

N 20 | N 11 | SM

A company has a book value per share of ₹ 137.80. Its return on equity is 15% and it follows a policy of retaining 60% of its earnings. If the Opportunity Cost of Capital is 18%, what is the price of the share today?

Solution:

$$\begin{aligned} \text{EPS} &= 137.80 \times 15\% = 20.67 \\ \text{DPS} &= 20.67 \times (1 - 0.60) = 8.268 \\ g &= 0.15 \times 0.060 = 9\% \\ \text{Price of share } (P_0) &= \frac{D_1}{K_e - g} \end{aligned}$$

$$= \frac{8.268}{0.18 - 0.09} = 91.87$$

**QUESTION 3:**

SM | M 21 | M 05

A company's beta is 1.40. The market return is 14%. The risk free rate is 10% (i) What is the expected return based on CAPM (ii) If the risk premium on the market goes up by 2.5% points, what would be the revised expected return on this stock?

Solution:

$$\begin{aligned} \text{Expected Return} &= R_f + \beta (R_m - R_f) \\ &= 10 + 1.40 (14 - 10) \\ &= 15.6\% \\ \text{Revised risk premium} &= (14\% - 10\%) + 2.5\% \\ &= 6.5\% \\ \text{Revised expected return} &= 10 + 1.40 (6.5) \\ &= 19.1\% \end{aligned}$$

**QUESTION 4:**

N 21

Following are the details of X Ltd. and Y Ltd.:

Particulars	X Ltd.	Y Ltd.
Dividend per Share	₹ 4	₹ 4
Growth Rate	10%	10%
Beta	0.9	1.2
Current Market Price per Share	₹ 150	₹ 70

Other Information:

Risk Free Rate of Return 7%

Market Rate of Return 14%

- Calculate the price of shares of both the companies.
- Write the comment on the valuation on the basis of price calculated and current market price.
- As an investor what course of action should be followed?

Solution:

- a) Calculation of Prices of shares of both companies:

	X Ltd.	Y Ltd.
Beta	0.9	1.20

Cost of Equity using CAPM	= 7% + 0.9 [14% - 7%] = 13.30%	= 7% + 1.20 [14% - 7%] = 15.40%
Growth Rate	10%	10%
Price of Share	= $\frac{4.00}{0.133 - 0.10}$ = ₹ 121.21	= $\frac{4.00}{0.154 - 0.10}$ = ₹ 74.07

b) and c) Comment on valuation and course of action:

company	CMP	Value	Valuation	Action of the Investor
X Ltd.	₹ 150.00	₹ 121.21	Overvalued	Sell
Y Ltd.	₹ 70.00	₹ 74.07	Undervalued	Buy



QUESTION 5:

M 15

The following information is collected from the annual reports of J Ltd:

Profit before tax	₹ 2.50 crore
Tax rate	40 percent
Retention ratio	40 percent
Number of Outstanding shares	50,00,000
Equity capitalization rate	12 percent
Rate of return on investment	15 percent

What should be the market price per share according to Gordon's model of dividend policy?

Solution:

PBT	2,50,00,000
Less: Tax @ 40%	(1,00,00,000)
EAES	1,50,00,000
÷ No. of shares	50,00,000
EPS	3

Calculation of DPS = $3 \times 0.60 = 1.80$

Calculation of growth = $0.40 \times 0.15 = 6\%$

Price of share (P_0) = $\frac{D_1}{K_e - g}$

$$= \frac{1.80}{0.12 - 0.06} = 30$$



QUESTION 6:

N 18 | N 13 | M 11 | M 05 | SM | RTP

Shares of Voyage Ltd. are being quoted at a price-earnings ratio of 8 times. The company retains ₹ 5 per share which is 50% of its Earning Per Share.

You are required to determine:

1. the cost of equity to the company if the market expects a growth rate of 15% p.a.
2. the indicative market price with the same cost of capital and if the anticipated growth rate is 16% p.a.
3. the market price per share if the company's cost of capital is 20% p.a. and the anticipated growth rate is 18% p.a.

Solution:

1.	Retained Earnings	₹ 5 per share
	Retention ratio	50%
	EPS	₹ 10
	DPS	₹ 5
	PF Ratio	8 times
	Market Price	₹ 10 × 8 times = ₹ 80

$$\begin{aligned} \text{Computation of cost of equity} &= \frac{D_1}{P_0} + g \\ &= \frac{5}{80} + 0.15 \\ &= 21.25\% \end{aligned}$$

$$\begin{aligned} 2. \quad \text{Market Price} &= \frac{D_1}{k_e - g} = \frac{5}{0.2125 - 0.16} \\ &= ₹ 95.24 \end{aligned}$$

$$\begin{aligned} 3. \quad \text{Market Price} &= \frac{D_1}{k_e - g} = \frac{5}{0.20 - 0.18} \\ &= ₹ 250 \end{aligned}$$



QUESTION 7:

MTP N 23 | M 18 | N 14

The risk-free rate of return R_f is 9 percent. The expected rate of return on the market portfolio R_m is 13 percent. The expected rate of growth for the dividend of Platinum Ltd. is 7 percent. The last

dividend paid on the equity stock of firm A was ₹ 2.00. The beta of Platinum Ltd. equity stock is 1.2.

- a. What is the equilibrium price of the equity stock of Platinum Ltd.?
- b. How would the equilibrium price change when:
 - The inflation premium increases by 2 percent?
 - The expected growth rate increases by 3 percent?
 - The beta of Platinum Ltd. equity rises to 1.3?

Solution:

- a. Calculation of cost of equity by using CAPM

$$\begin{aligned}
 &= R_f + \beta (R_m - R_f) \\
 &= 9 + 1.2 (13 - 9) \\
 &= 13.8\%
 \end{aligned}$$

Calculation of equilibrium price

$$\begin{aligned}
 &= \frac{D_1}{K_e - g} \\
 &= \frac{2(1 + 0.07)}{0.138 - 0.07} \\
 &= ₹ 31.47
 \end{aligned}$$

- b. Revised price after the change:

$$\begin{aligned}
 R_f &= 11\% \\
 R_m &= 15\% \\
 \text{Growth} &= 10\% \\
 \text{Beta} &= 1.3
 \end{aligned}$$

Calculation of K_e by using CAPM

$$\begin{aligned}
 &= R_f + \beta (R_m - R_f) \\
 &= 11 + 1.3 (15 - 11) \\
 &= 16.2\%
 \end{aligned}$$

Equilibrium price after the change:

$$\begin{aligned}
 &= \frac{D_1}{K_e - g} \\
 &= \frac{2 (1 + 0.1)}{0.162 - 0.10} \\
 &= 35.48
 \end{aligned}$$

**QUESTION 8:**

M 13 | SM | RTP

X Limited just declared a dividend of ₹ 14.00 per share. Mr. B is planning to purchase the share of X Limited, anticipating increase in growth rate from 8% to 9%, which will continue for three years. He also expects the market price of this share to be ₹ 360.00 after three years.

You are required to determine:

- The maximum amount Mr. B should pay for shares, if he requires a rate of return of 13% per annum.
- The maximum price Mr. B will be willing to pay for share, if he is of the opinion that the 9% growth can be maintained indefinitely and require 13% rate of return per annum.
- The price of share at the end of three years if 9% growth rate is achieved and assuming other conditions remaining same as in (ii) above.

Calculate rupee amount up to two decimal points.

	Year - 1	Year - 2	Year - 3
FVIF @ 9%	1.090	1.188	1.295
FVIF @ 13%	1.130	1.277	1.443
PVIF @ 13%	0.885	0.783	0.693

Solution:

- a) Calculation of Dividends

Year	0	1	2	3	4
Growth		9%	9%	9%	9%
Dividend	14	15.26	16.63	18.13	19.76

The maximum amount Mr. B should pay for share

Year	CF's	PVAF@13%	PV
1	15.26	0.885	13.5051
2	16.63	0.783	13.0213
3	18.13 + 360	0.693	262.044
Max Amount			288.57

- b. Gordon's formula

If growth rate 9% is achieved for indefinite period, then maximum price of share should Mr. A willing be to pay is

$$\begin{aligned}
 &= \frac{D_1}{K_e - g} \\
 &= \frac{15.26}{0.13 - 0.09} \\
 &= ₹ 381.5
 \end{aligned}$$

c. Max price paid of the end of 3 year

$$\begin{aligned} P_3 &= \frac{D_4}{k_e - g} \\ &= \frac{19.7621}{0.13 - 0.09} \\ &= ₹ 494.05 \end{aligned}$$



QUESTION 9:

M 21

NM Ltd. (NML) is aspiring to enter the capital market in a three years' time. The Board wants to attain the target price of ₹ 70 for its shares at the end of three years. The present value of its shares is ₹ 52.03. The dividend is expected to grow at a rate of 15% for the next three years. NML uses dividend growth model for its projections.

The required rate of return is 15%.

You are required to calculate the amount of dividend to be declared by the board in the base year so as to achieve the target price.

Period (t)	1	2	3
PVIF (15%, t)	0.8696	0.7561	0.6575

Solution:

$$\begin{aligned} \text{value of Share} &= \text{PV of Dividend for 3 years} + \text{PV of Target price after 3 years} \\ ₹ 52.03 &= \text{PV of Dividend for 3 years} + 70.00 \times 0.6575 \\ \text{PV of Dividend for 3 years} &= ₹ 52.03 - ₹ 46.03 = ₹ 6 \end{aligned}$$

Let Base Dividend is D_0 , then

$$\begin{aligned} 6 &= D_0 (1+g) \times \text{PVIF}_{(15\%,1)} + D_0 (1+g)^2 \times \text{PVIF}_{(15\%,2)} + D_0 (1+g)^3 \times \text{PVIF}_{(15\%,3)} \\ 6 &= D_0 (1.15) \times 0.8696 + D_0 (1.15)^2 \times 0.7561 + D_0 (1.15)^3 \times 0.6575 \\ D_0 &= 2 \end{aligned}$$

Thus, Company should declare a dividend of ₹ 2 in base year.



QUESTION 10:

MTP M 15

SRK Ltd. is a listed company and it has just announced annual dividend for the year ending 2013-14. Earnings Per Share (EPS) and Dividend Per Share (DPS) for 5 years is as follows:

₹	2013-14	2012-13	2011-12	2010-11	2009-10
EPS	14	13.6	13.1	12.7	12.2
DPS	8.2	8.1	7.9	7.8	7.7

In the opinion of MD of SRK Ltd., if current dividend policy is maintained annual growth in Earnings and Dividends will be no better than the annual growth in earnings over the past years

Since the Board of SRK Ltd. is reluctant to take debt to finance growth it is considering changing its dividend policy by retaining 50% of its earnings for investment in various projects having a post-tax rate of return of 15%. The beta of SRK Ltd. is 1.5, market risk premium is 4% and Risk Free Rate of Return is 6%.

You are required to calculate expected market price of share, if

- SRK Ltd. does not announce a change in its Dividend Policy.
- SRK Ltd. does announce a change in its Dividend Policy by retaining 50% of its earnings.

Note: Growth Rate can be assumed to be remain stable.

Solution:

- a) Calculation of cost of equity using CAPM

$$\begin{aligned}K_e &= R_f + \beta (R_m - R_f) \\ &= 6 + 1.5 (4) \\ &= 12\%\end{aligned}$$

$$\text{Average Growth Rate} = \left(\frac{14.00}{12.20} \right)^{1/4} - 1 = 3.5\%$$

Calculation of MP by Gordon's formula

$$\begin{aligned}P_0 &= \frac{D_1}{K_e - g} \\ &= \frac{8.2 \times 1.035}{0.12 - 0.035} \\ &= 99.85\end{aligned}$$

- b) Dividend Payout Ratio: = 50%

$$RR = 1 - 0.5 = 50\%$$

$$ROE = 15\%$$

Calculation of growth rate

$$\begin{aligned}&= RR \times ROE \\ &= 0.50 \times 0.15 \\ &= 7.5\%\end{aligned}$$

$$\begin{aligned}D_1 &= 14 \times 50\% \times 1.075 \\ &= 7.525\%\end{aligned}$$

$$\begin{aligned}P_0 &= \frac{D_1}{K_e - g} \\ &= \frac{7.525}{0.12 - 0.075} \\ &= 167.22\end{aligned}$$