MOCK TEST PAPER – 2

FINAL (OLD) COURSE: GROUP – I

PAPER – 2: STRATEGIC FINANCIAL MANAGEMENT

SUGGESTED ANSWERS/HINTS

1. (a) Future's Price = Spot + cost of carry – Dividend

F = 220 + 220 × 0.15 × 0.25 – 0.25** × 10 = 225.75

** Entire 25% dividend is payable before expiry, which is Rs.2.50.

Thus we see that futures price by calculation is Rs. 225.75 which is quoted at Rs. 230 in the exchange.

Analysis:

Fair value of Futures less than Actual futures Price:

Futures Overvalued Hence it is advised to sell. Also do Arbitraging by buying stock in the cash market.

Step I

He will buy PQR Stock at Rs.220 by borrowing at 15% for 3 months. Therefore, his outflows are:

Cost of Stock	220.00
Add: Interest @ 15 % for 3 months i.e. 0.25 years (220 × 0.15 × 0.25)	8.25
Total Outflows (A)	228.25

Step II

He will sell March 2000 futures at Rs.230. Meanwhile he would receive dividend for his stock.

Hence his inflows are	230.00
Sale proceeds of March 2000 futures	2.50
Total inflows (B)	232.50

Inflow – Outflow = Profit earned by Arbitrageur

= 232.50 – 228.25 = 4.25

(b) No. of Shares = $\frac{₹\ 1,300\ \text{crores}}{₹\ 40}$ = 32.5 Crores

$$EPS = \frac{PAT}{No.\ of\ shares}$$

$$EPS = \frac{₹\ 290\ \text{crores}}{32.5\ \text{crores}} = \text{Rs. } 8.923$$

FCFE = Net income – [(1-b) (capex – dep) + (1-b) (ΔWC)]

FCFE = 8.923 – [(1-0.27) (47-39) + (1-0.27) (3.45)]

= 8.923 – [5.84 + 2.5185] = 0.5645

Cost of Equity = R_f + ß (R_m – R_f)

= 8.7 + 0.1 (10.3 – 8.7) = 8.86%

$$Po = \frac{FCFE(1+g)}{K_e - g} = \frac{0.5645(1.08)}{0.0886 - .08} = \frac{0.60966}{0.0086} = \text{Rs. } 70.8$$

(c) (i) The GOI Security has semi-annual coupon of 30 April hence the accrual period is 1 May 2015 to 30 June 2015 i.e. 61 days. Therefore,

$$\text{Accrued Interest on Security} = 10000 \times \frac{10}{100} \times \frac{61}{365} = \text{Rs. } 167.12$$

Dirty Price = Rs. 9,872 + Rs. 167.12 = Rs. 10,039.12

$$\text{Dirty Price Adjusted for 3\% haircut} = \frac{10039.12}{1.03} = \text{Rs. } 9,746.72$$

$$\text{Nominal Amount of Securities Required} = 400 \times \frac{10000}{9746.72} = \text{Rs. } 410.39447 \text{ crore}$$

$$\text{No. of securities required} = \frac{410.39447}{9746.72} = 4,21,059 \text{ (Approx.)}$$

(ii) The original cash amount to be repaid at the end

$$\text{Rs. } 400 \text{ crore} \times \left(1 + 0.1165 \times \frac{14}{365}\right) = \text{Rs. } 401.7874 \text{ crore}$$

(d) (i) According to Dividend Discount Model approach the firm's expected or required return on equity is computed as follows:

$$= \frac{D_1}{P_0} + g$$

Where,

K_e = Cost of equity share capital

D_1 = Expected dividend at the end of year 1

P_0 = Current market price of the share.

g = Expected growth rate of dividend.

$$\text{Therefore, } K_e = \frac{3.36}{146} + 7.5\%$$

= 0.0230 +0.075 = 0.098

Or, K_e = 9.80%

(ii) With rate of return on retained earnings (r) 10% and retention ratio (b) 60%, new growth rate will be as follows:

g= br i.e.

= 0.10 X 0.60 = 0.06

Accordingly dividend will also get changed and to calculate this, first we shall calculate previous retention ratio (b_1) and then EPS assuming that rate of return on retained earnings (r) is same.

With previous Growth Rate of 7.5% and r =10% the retention ratio comes out to be:

0.075 = b_1 X 0.10

b_1 = 0.75 and payout ratio = 0.25

With 0.25 payout ratio the EPS will be as follows:

$$\frac{3.36}{0.25} = 13.44$$

With new 0.40 (1 – 0.60) payout ratio the new dividend will be

$D_1 = 13.44 \text{ X } 0.40 = 5.376$

Accordingly new K_e will be

$$K_e = \frac{5.376}{146} + 6.0\%$$

or, $K_e = 9.68\%$

Alternatively

EPS with 6% growth rate instead of 7.5%.

$$13.44 \times \frac{1.06}{1.075} = 13.25$$

With new 0.40 (1 – 0.60) payout ratio the new dividend will be

$D_1 = 13.25 \text{ X } 0.40 = 5.30$

Accordingly new K_e will be

$$K_e = \frac{5.30}{146} + 6.0\%$$

or, $K_e = 9.63\%$

2. (a)

(A)	Cash Outflow		Rs.
	(i)	In case machine is upgraded:	
		Upgradation Cost	10,00,000
	(ii)	In case new machine installed:	
		Cost	20,00,000
		Add: Installation cost	50,000
		Total Cost	20,50,000
		Less: Disposal of old machine	
		Rs. 50,000 – 40% tax	30,000
		Total Cash Outflow	20,20,000

Working Note:

(i) Depreciation – in case machine is upgraded

Rs. 10,00,000 ÷ 5 = Rs. 2,00,000

(ii) Depreciation – in case new machine is installed

Rs. 20,50,000 ÷ 5 = Rs. 4,10,000

(iii) Old existing machine – Book Value is zero. So no depreciation.

(B) Cash Inflows after Taxes (CFAT)

Year	Old Existing Machine	Upgraded Machine			
	(i) EAT/CFAT Rs.	(ii) EAT Rs.	(iii) DEP Rs.	(iv) CFAT Rs.	= (iv)-(i) Incremental CFAT Rs.
1	5,00,000	5,50,000	2,00,000	7,50,000	2,50,000
2	5,40,000	5,90,000	2,00,000	7,90,000	2,50,000
3	5,80,000	6,10,000	2,00,000	8,10,000	2,30,000
4	6,20,000	6,50,000	2,00,000	8,50,000	2,30,000
5	6,60,000	7,00,000	2,00,000	9,00,000	2,40,000

Cash Inflow after Taxes (CFAT)

Year		New Machine		
	(vi) EAT Rs.	(vii) DEP Rs.	(viii) CFAT Rs.	(ix) = (viii) – (i) Incremental CFAT (Rs.)
1	6,00,000	4,10,000	10,10,000	5,10,000
2	6,40,000	4,10,000	10,50,000	5,10,000
3	6,90,000	4,10,000	11,00,000	5,20,000
4	7,40,000	4,10,000	11,50,000	5,30,000
5	8,00,000	4,10,000	12,10,000	5,50,000

P.V. AT 15% - 5 Years – on Incremental CFAT

Year	Upgraded Machine			New Machine		
	Incremental CFAT Rs.	PVF	Total P.V. Rs.	Incremental CFAT	PVF	Total PV Rs.
1	2,50,000	0.870	2,17,500	5,10,000	0.870	4,43,700
2	2,50,000	0.756	1,89,000	5,10,000	0.756	3,85,560
3	2,30,000	0.658	1,51,340	5,20,000	0.658	3,42,160
4	2,30,000	0.572	1,31,560	5,30,000	0.572	3,03,160
5.	2,40,000	0.497	1,19,280	5,50,000	0.497	2,73,350
Total P.V. of CFAT			8,08,680			17,47,930
Less: Cash Outflows			10,00,000			20,20,000*
N.P.V. =			-1,91,320			- 2,72,070

*Acquisition Cost (including installation cost) Rs. 20,50,000

Less: Salvage Value of existing machine net of Tax Rs. 30,000

Rs. 20,20,000

As the NPV in both the new (alternative) proposals is negative, the company should continue with the existing old Machine.

(b) (a) By entering into an FRA, firm shall effectively lock in interest rate for a specified future in the given it is 6 months. Since, the period of 6 months is starting in 3 months, the firm shall opt for 3 × 9 FRA locking borrowing rate at 5.94%. In the given scenarios, the net outcome shall be as follows:

	If the rate turns out to be 4.50%	**If the rate turns out to be 6.50%**
FRA Rate	5.94%	5.94%
Actual Interest Rate	4.50%	6.50%
Loss/ (Gain)	1.44%	(0.56%)
FRA Payment / (Receipts)	€50 m × 1.44% × ½ = €360,000	€50m × 0.56% × ½ = (€140,000)
Interest after 6 months on €50 Million at actual rates	= €50m × 4.5% × ½ = €1,125,000	= € 50m × 6.5% × ½ = €1,625,000
Net Out Flow	€ 1,485,000	€1,485,000

Thus, by entering into FRA, the firm has committed itself to a rate of 5.94% as follows:

$$\frac{€\ 1,485,000}{€\ 50,000,000} \times 100 \times \frac{12}{6} = 5.94\%$$

(b) Since firm is a borrower it will like to off-set interest cost by profit on Future Contract. Accordingly, if interest rate rises it will gain hence it should sell interest rate futures.

$$\text{No. of Contracts} = \frac{\text{Amount of Borrowing}}{\text{Contract Size}} \times \frac{\text{Duration of Loan}}{\text{3 months}}$$

$$= \frac{€\ 50,000,000}{€\ 50,000} \times \frac{6}{3} = 2000 \text{ Contracts}$$

The final outcome in the given two scenarios shall be as follows:

	If the interest rate turns out to be 4.5%	**If the interest rate turns out to be 6.5%**
Future Course Action :		
Sell to open	94.15	94.15
Buy to close	95.50 (100 - 4.5)	93.50 (100 - 6.5)
Loss/ (Gain)	1.35%	(0.65%)
Cash Payment (Receipt) for Future Settlement	€50,000×2000× 1.35%×3/12 = €337,500	€50,000×2000×0.65%×3/12 = (€162,500)
Interest for 6 months on €50 million at actual rates	€50 million × 4.5% × ½ = €11,25,000	€50 million × 6.5% × ½ = €16,25,000
	€1,462,500	€1,462,500

Thus, the firm locked itself in interest rate $\frac{€\ 1,462,500}{€\ 50,000,000} \times 100 \times \frac{12}{6} = 5.85\%$

3. (a) Alternative I: Acquiring the asset by taking bank loan:

Years		1	2	3	4	5
(a)	Interest (@15% p.a. on opening balance)	150,000	120,000	90,000	60,000	30,000

	Depreciation (@15%WDV)	150,000	127,500	108,375	92,119	78,301
		300,000	247,500	198,375	152,119	108,301
(b)	Tax shield (@35%)	105,000	86,625	69,431	53,242	37,905
	Interest less Tax shield (a)-(b)	45,000	33,375	20,569	6,758	(-)7,905
	Principal Repayment	2,00,000	2,00,000	2,00,000	2,00,000	2,00,000
	Total cash outflow	2,45,000	2,33,375	2,20,569	2,06,758	1,92,095
	Discounting Factor @ 16%	0.862	0.743	0.641	0.552	0.476
	Present Value	2,11,190	1,73,398	1,41,385	1,14,130	91,437

Total P.V of cash outflow = Rs.731,540

Alternative II: Acquire the asset on lease basis

Year	Lease Rentals Rs.	Tax Shield @35%	Net Cash Outflow	Discount Factor	Present Value
1	3,34,000	1,16,900	2,17,100	0.862	1,87,140
2	3,34,000	1,16,900	2,17,100	0.743	1,61,305
3	3,34,000	1,16,900	2,17,100	0.641	1,39,161
4	3,34,000	1,16,900	2,17,100	0.552	1,19,839
5	3,34,000	1,16,900	2,17,100	0.476	1,03,340
				Present value of Total Cash out flow	7,10,785

Advice -By making Analysis of both the alternatives, it is observed that the present value of the cash outflow is lower in alternative II by Rs.20,755 (i.e.Rs.731,540 – Rs.7,10,785) Hence, it is suggested to acquire the asset on lease basis.

(b) (i) Working for calculation of WACC

	Orange	Grape	Apple
Total debt	80,000	50,000	20,000
Post tax Cost of debt	10.4%	8.45%	9.75%
Equity Fund	20,000	50,000	80,000

WACC

Orange: (10.4 x 0.8) + (26 x 0.2) = 13.52%

Grape: (8.45 x 0.5) + (22 x 0.5) = 15.225%

Apple: (9.75 x 0.2) + (20 x 0.8) = 17.95%

(ii)

	Orange	Grape	Apple
WACC	13.52	15.225	17.95
EVA [EBIT (1-T) - (WACC x Invested Capital)]	2,730	1,025	-1,700

Alternatively, it can also be computed as follows:

	Orange	Grape	Apple
Net Income (Rs.)	8,970	12,350	14,950
Pre Tax Income (Rs.) (A)	13,800	19,000	23,000
Debt Amount (Rs.)	80,000	50,000	20,000

Interest (Rs.) (B)	12,800	6,500	3,000
EBIT (Rs.)	26,600	25,500	26,000
Tax 35% (Rs.)	9,310	8,925	9,100
EAT	17,290	16,575	16,900
Less: WACC X Invested Capital	13,520	15,220	17,950
EVA (Rs.)	3,770	1,355	-1,050

(iii) Orange would be considered as the best investment since the EVA of the company is highest and its weighted average cost of capital is the lowest

(iv) Estimated Price of each company shares

	Orange	Grape	Apple
EBIT (Rs.)	25,000	25,000	25,000
Interest (Rs.)	12,800	6,500	3,000
Taxable Income (Rs.)	12,200	18,500	22,000
Tax 35% (Rs.)	4,270	6,475	7,700
Net Income (Rs.)	7,930	12,025	14,300
Shares	6,100	8,300	10,000
EPS (Rs.)	1.3	1.448795	1.43
Stock Price (EPS x PE Ratio) (Rs.)	14.30	15.94	15.73

Since the three entities have different capital structures they would be exposed to different degrees of financial risk. The PE ratio should therefore be adjusted for the risk factor.

Alternative Answer

	Orange	Grape	Apple
Net Income (Given) (Rs.)	8,970	12,350	14,950
Shares	6,100	8,300	10,000
EPS (Rs.)	1.4705	1.488	1.495
Stock Price (EPS x PE Ratio) (Rs.)	16.18	16.37	16.45

(v) Market Capitalisation

Estimated Stock Price (Rs.)	14.30	15.94	15.73
No. of shares	6,100	8,300	10,000
Estimated Market Cap (Rs.)	87,230	1,32,302	1,57,300

Alternative Answer

Estimated Stock Price (Rs.)	16.18	16.37	16.45
No. of shares	6,100	8,300	10,000
Estimated Market Cap (Rs.)	98,698	1,35,871	1,64,500

4. (a)

Calculation of return on portfolio for 2009-10	(Calculation in Rs. / share)		
	M	N	
Dividend received during the year	10	3	
Capital gain/loss by 31.03.10			
Market value by 31.03.10	220	290	

Cost of investment	200	300	
Gain/loss	20	(-)10	
Yield	30	(-)7	
Cost	200	300	
% return	15%	(-)2.33%	
Weight in the portfolio	57	43	
Weighted average return			7.55%
Calculation of estimated return for 2010-11			
Expected dividend	20	3.5	
Capital gain by 31.03.11			
(220x0.2)+ (250x0.5)+(280x0.3) – 220=(253-220)	33	-	
(290x0.2)+(310x0.5)+(330x0.3) – 290= (312 – 290)	-	22	
Yield	53	25.5	
*Market Value 01.04.10	220	290	
% return	24.09%	8.79%	
*Weight in portfolio (1,000x220): (500x290)	60.3	39.7	
Weighted average (Expected) return			18.02%
(*The market value on 31.03.10 is used as the base for calculating yield for 10-11)			

Calculation of Standard Deviation

M Ltd.

Exp. market value	*Exp. gain*	*Exp. div.*	*Exp Yield (1)*	*Prob. Factor (2)*	(1) X (2)	*Dev. (P_M-$\overline{P_M}$)*	*Square of dev. (3)*	(2) X (3)
220	0	20	20	0.2	4	-33	1089	217.80
250	30	20	50	0.5	25	-3	9	4.50
280	60	20	80	0.3	24	27	729	218.70
					53			σ^2_M = 441.00

Standard Deviation (σ_M) 21

N Ltd.

Exp. market value	*Exp. gain*	*Exp. div.*	*Exp Yield (1)*	*Prob. Factor (2)*	(1) X (2)	*Dev. (P_N-$\overline{P_N}$)*	*Square of dev. (3)*	(2) X (3)
290	0	3.5	3.5	0.2	0.7	-22	484	96.80
310	20	3.5	23.5	0.5	11.75	-2	4	2.00
330	40	3.5	43.5	0.3	13.05	18	324	97.20
					25.5			σ^2_N = 196.00

Standard Deviation (σ_N) 14

Share of company M Ltd. is more risky as the S.D. is more than company N Ltd.

(b)

Particulars	Rs.
Estimated Receivables	46,00,000
Estimated Receivables under Factor $\left(3,74,00,000 \times \frac{30}{365}\right)$	30,73,973
Reduction in Receivables (Rs. 46,00,000 – Rs. 30,73,973)	15,26,027

Total Savings (A)

Reduction in finance costs	Rs. 15,26,027 @ 5%	76,301
Saving of Administration costs		1,00,000
Saving of Bad debts		3,50,000
Total		5,26,301

Total Cost of Factoring (B)

Interest on advances by Factor		
Advances 30,73,973 @ 80% Rs. 24,59,178		
Interest on Rs. 24,59,178 @ 7%	Rs. 1,72,142	
Overdraft Interest rate 5%	(Rs. 1,22,959)	49,183
Charges payable to Factor (Rs. 3,74,00,000 @ 3%)		11,22,000
Total		11,71,183

Net Saving (A) – (B) (6,44,882)

Since Net Saving is negative the proposal is not viable and cannot be accepted

5. (a) (i) Number of Units in each Scheme

MF 'X'	$\frac{\text{Rs. } 2,00,000}{\text{Rs. } 10.30}$	= 19,417.48
MF 'Y'	$\frac{\text{Rs. } 4,00,000}{\text{Rs. } 10.10}$	= 39,603.96
MF 'Z'	$\frac{\text{Rs. } 2,00,000}{\text{Rs. } 10.00}$	= 20,000.00

(ii) Total NAV on 31.03.2018

MF 'X'	= 19,417.48 x Rs. 10.25	Rs. 1,99,029.17
MF 'Y'	= 39,603.96 x Rs. 10.00	Rs. 3,96,039.60
MF 'Z'	= 20,000.00 x Rs. 10.20	Rs. 2,04,000.00
Total		Rs. 7,99,068.77

(iii) Total Yield

	Capital Yield	Dividend Yield	Total
MF 'X'	Rs. 1,99,029.17- Rs. 2,00,000 = - Rs. 970.83	Rs. 6,000	Rs. 5,029.17
MF 'Y'	Rs. 3,96,039.60 - Rs. 4,00,000 = - Rs. 3,960.40	Nil	- Rs. 3,960.40

MF 'Z'	Rs. 2,04,000 - Rs. 2,00,000 = Rs. 4,000	Rs. 5,000	Rs. 9,000.00
Total			Rs. 10,068.77

Total Yield = $\frac{\text{Rs. } 10,068.77}{\text{Rs. } 8,00,000} \times 100 = 1.2586\%$

(iv) No. of Days Investment Held

	MF 'X'	MF 'Y'	MF 'Z'
Let No. of days be	X	Y	Z
Initial Investment (Rs.)	2,00,000	4,00,000	2,00,000
Yield (Rs.)	5,029.17	-3,960.40	9,000.00
Yield (%)	2.5146	- 0.9901	4.5
Period of Holding (Days)	$\frac{2.5146}{9.66} \times 365$ = 95 Days	$\frac{-0.9901}{-11.66} \times 365$ = 31 Days	$\frac{4.5}{24.15} \times 365$ = 68 Days
Date of Original Investment	26.12.17	28.02.18	22.01.18

(b) Conversion Price = Rs. 50 x 17 = Rs. 850

Intrinsic Value = Rs. 850

Accordingly the yield (r) on the bond shall be :

Rs. 850 = Rs. 100 PVAF (r, 10) + Rs. 1000 PVF (r, 10)

Let us discount the cash flows by 11%

850 = 100 PVAF (11%, 10) + 1000 PVF (11%, 10)

850 = 100 x 5.890 + 1000 x 0.352

= 91

Now let us discount the cash flows by 13%

850 = 100 PVAF (13%, 10) + 1000 PVF (13%, 10)

850 = 100 x 5.426 + 1000 x 0.295

= -12.40

Accordingly, IRR

$$11\% + \frac{90.90}{90.90 - (-12.40)} \times (13\% - 11\%)$$

$$11\% + \frac{90.90}{103.30} \times (13\% - 11\%)$$

= 12.76%

The spread from comparable bond = 12.76% - 11.80% = 0.96%

6. (a) (i) Return of a US Investor

$$= \frac{\text{Ending Price - Initial Price}}{\text{Initial Price}} \times 100$$

$= \frac{1919 - 2028}{2028} \times 100 = -5.37\%$

(ii) Return of Mr. X

Initial Investment (Rs.)	1.58 Crore
Applicable Exchange Rate on 1.1.20x1	Rs. 62.25
Equivalent US$	US$ 2,53,815.26
Purchase Price of Standard & Poor Index	2028
No. of Standard & Poor Indices Purchased	125.16
Ending Price of Standard & Poor Index	1919
Proceeds realised in US$ on sale of Standard & Poor Index	US$ 2,40,182.04
Applicable Exchange Rate on 1.1.20x2	Rs. 67.25
Proceeds realised in INR on sale of Standard & Poor Index	Rs. 1,61,52,242
Rate of Return $(\frac{16152242 - 15800000}{15800000} \times 100)$	2.23%

(iii) Rate of Return had the amount been invested in India

Initial Investment (Rs.)	1.58 Crore
Purchase Price of Indian Index	7395
No. of Standard & Poor Indices Purchased	2136.58
Let Ending Price of Indian Index	X
Then to be indifferent with return in International Market	$\frac{2136.58 \times X - 1.58}{1.58} \times 100 = 2.23$
Price of Indian Index to be indifferent	7559.90 say 7560

(b) Firstly, the interest is calculated at 3% p.a. for 6 months. That is:

USD 20,00,000 × 3/100 × 6/12 = USD 30,000

From the forward points quoted, it is seen that the second figure is less than the first, this means that the currency is quoted at a discount.

(i) The value of the total commitment in Indian rupees is calculated as below:

Principal Amount of loan	USD 20,00,000
Add: Interest	USD 30,000
Amount due	USD 20,30,000
Spot rate	Rs. 48.5275
Forward Points (6 months)	(–) 0.0700
Forward Rate	Rs. 48.4575
Value of Commitment	Rs. 9,83,68,725

(ii) It is seen from the forward rates that the market expectation is that the dollar will depreciate. If the firm's own expectation is that the dollar will depreciate more than what the bank has quoted, it may be worthwhile not to cover forward and keep the exposure open.

If the firm has no specific view regarding future dollar price movements, it would be better to cover the exposure. This would freeze the total commitment and insulate the firm from

undue market fluctuations. In other words, it will be advisable to cut the losses at this point of time.

Given the interest rate differentials and inflation rates between India and USA, it would be unwise to expect continuous depreciation of the dollar. The US Dollar is a stronger currency than the Indian Rupee based on past trends and it would be advisable to cover the exposure.

7. (a) A 'Reverse Stock Split' is a process whereby a company decreases the number of shares outstanding by combining current shares into fewer or lesser number of shares. For example, in a 5 : 1 reverse split, a company would take back 5 shares and will replace them with one share.

Although, reverse stock split does not result in change in Market value or Market Capitalization of the company, but it results in increase in price per share.

Considering above mentioned ratio, if company has 100 million shares outstanding having Market Capitalisation of Rs. 500 crore before split up, the number of shares would be equal to 20 million after the reverse split up and market price of one share shall increase from Rs. 50 to Rs. 250.

Reasons for Reverse Split Up

Although Reverse Split up is not so popular especially in India but company carries out reverse split up due to following reasons:

(i) Avoiding delisting from stock exchange: Sometimes as per the stock exchange regulations if the price of shares of a company goes below a certain limit it can be delisted. To avoid such delisting company may resort to reverse stock split up.

(ii) Avoiding removal from constituents of Index: If company's share is one of the constituents of the market index then to avoid their removal of scrip from this list due to persistent fall in the prices of share, the company may take reverse split up route.

(iii) To avoid the tag of "Penny Stock": If the price of shares of a company goes below a limit it may be called "Penny Stock". In order to improve the image of the company and avoiding this stage, the company may go for Reverse Stock Split.

(iv) To attract Institutional Investors and Mutual Funds: It might be possible that institutional investors may be shying away from acquiring low value shares and hence to attract these investors the company may adopt the route of Reverse Stock Split up to increase the price per share.

(b) The interface of strategic management and financial policy will be clearly understood if we appreciate the fact that the starting point of an organization is money and the end point of that organization is also money. No organization can run an existing business and promote a new expansion project without a suitable internally mobilized financial base or both internally and externally mobilized financial base.

Sources of finance and capital structure are the most important dimensions of a strategic plan. The generation of funds may arise out of ownership capital and or borrowed capital. A company may issue equity shares and / or preference shares for mobilizing ownership capital.

Along with the mobilization of funds, policy makers should decide on the capital structure to indicate the desired mix of equity capital and debt capital. There are some norms for debt equity ratio. However this ratio in its ideal form varies from industry to industry. It also depends on the planning mode of the organization under study.

Another important dimension of strategic management and financial policy interface is the investment and fund allocation decisions. A planner has to frame policies for regulating investments in fixed assets and for restraining of current assets. Investment proposals mooted by different business units may be addition of a new product, increasing the level of operation of an

existing product and cost reduction and efficient utilization of resources through a new approach and or closer monitoring of the different critical activities.

Now, given these three types of proposals a planner should evaluate each one of them by making within group comparison in the light of capital budgeting exercise.

Dividend policy is yet another area for making financial policy decisions affecting the strategic performance of the company. A close interface is needed to frame the policy to be beneficial for all. Dividend policy decision deals with the extent of earnings to be distributed as dividend and the extent of earnings to be retained for future expansion scheme of the firm.

It may be noted from the above discussions that financial policy of a company cannot be worked out in isolation of other functional policies. It has a wider appeal and closer link with the overall organizational performance and direction of growth. These policies being related to external awareness about the firm, specially the awareness of the investors about the firm, in respect of its internal performance. There is always a process of evaluation active in the minds of the current and future stake holders of the company. As a result preference and patronage for the company depends significantly on the financial policy framework. And hence attention of the corporate planners must be drawn while framing the financial policies not at a later stage but during the stage of corporate planning itself.

(c) Marking to market

It implies the process of recording the investments in traded securities (shares, debt-instruments, etc.) at a value, which reflects the market value of securities on the reporting date. In the context of derivatives trading, the futures contracts are marked to market on periodic (or daily) basis. Marking to market essentially means that at the end of a trading session, all outstanding contracts are repriced at the settlement price of that session. Unlike the forward contracts, the future contracts are repriced every day. Any loss or profit resulting from repricing would be debited or credited to the margin account of the broker. It, therefore, provides an opportunity to calculate the extent of liability on the basis of repricing. Thus, the futures contracts provide better risk management measure as compared to forward contracts.

Suppose on 1st day we take a long position, say at a price of Rs. 100 to be matured on 7th day. Now on 2nd day if the price goes up to Rs. 105, the contract will be repriced at Rs. 105 at the end of the trading session and profit of Rs. 5 will be credited to the account of the buyer. This profit of Rs. 5 may be drawn and thus cash flow also increases. This marking to market will result in three things – one, you will get a cash profit of Rs. 5; second, the existing contract at a price of Rs. 100 would stand cancelled; and third you will receive a new futures contract at Rs. 105. In essence, the marking to market feature implies that the value of the futures contract is set to zero at the end of each trading day.

(d) Debt route for foreign exchange funds:

The following are some of the instruments used for borrowing of funds from the international market:

(i) *Syndicated bank loans*: The borrower should obtain a good credit rating from the rating agencies. Large loans can be obtained in a reasonably short period with few formalities. Duration of the loan is generally 5 to 10 years. Interest rate is based on LIBOR plus spread depending upon the rating. Some covenants are laid down by the lending institutions like maintenance of key financial ratios.

(ii) *Euro bonds*: These are basically debt instruments denominated in a currency issued outside the country of the currency. For example, Yen bond floated in France. Primary attraction of these bonds is the shelter from tax and regulations which provide Scope for arbitraging yields. These are usually bearer bonds and can take the form of (i) traditional fixed rate bonds (ii) floating rate notes (FRN's) (iii) Convertible bonds.

(iii) *Foreign bonds*: Foreign bonds are foreign currency bonds and sold at the country of that currency and are subject to the restrictions as placed by that country on the foreigners' funds.

(iv) *Euro Commercial Papers*: These are short term money market securities usually issued at a discount, for maturity in less than one year.

(v) *External Commercial Borrowings (ECB's)*: These include commercial bank loans, buyer's credit and supplier's credit, securitised instruments such as floating rate notes and fixed rate bonds, credit from official export credit agencies and commercial borrowings from multi-lateral financial institutions like IFCI, ADB etc. External Commercial borrowings have been a popular source of financing for most of capital goods imports. They are gaining importance due to liberalization of restrictions. ECB's are subject to overall ceilings with sub-ceilings fixed by the government from time to time.

(vi) All other loans are approved by the government.

(e) REITs resembles a mutual fund (MF), wherein several investors pool in funds with real estate as the underlying asset class. Also, similar to MFs, REITs will be available in demat form and will be regulated by SEBI. That is where the similarities end. This is because the structure and the working of a REIT is completely different from a mutual fund scheme.

Reit is an investment vehicle which enables individual investors to earn income through the underlying commercial real estate, without directly owning it. The market experts speculate that Reit would act as a game changer since it can bring the much-required liquidity in the market with investment from retail and institutional investors.

It is difficult for a retail investor to get exposure to commercial real estate directly as the investment required is very high. For grade-A commercial property, it could be Rs. 5 crore and above. Exiting such large investments can also be time-consuming. Many of these challenges of investing in commercial real estate get taken care of when an investor takes the Reit route. Investors can enter Reits with just Rs 2 lakh investment. Exiting these investments should also be less difficult as units of Reits are listed on the stock exchanges.

Reit is an investment vehicle which allows an investor to hold a share in the underlying real estate property. It is similar to the concept of a mutual fund, where a fund pools small sums from individuals and institution and invests in stocks. In Reit, the trust puts money in property. The investments can be made through a trust directly or via Special Purpose Vehicles (SPV). An SPV is a company or a limited liability partnership (LLP) in which a Reit holds or proposes to hold an equity stake or interest of at least 50 per cent. An SPV is not allowed to engage in any activity other than holding and developing a property and any incidental activity.