Paper 20 – Financial Analysis & Business Valuation

Paper 20 – Financial Analysis & Business Valuation

Full Marks: 100 **Time allowed: 3 hours**

Question No. 1 which is compulsory and carries 20 marks and answer any five questions from Question No. 2 to Question No. 8

1.(a) State whether the following statements are true or false: **[1×8=8]**

(i) Realistic, error free and flexible are not the attributes of a good financial model.
(ii) If EPS of a company is ₹ 15 and the PE ratio is 10, then market value of the share of the company is ₹ 1.5.
(iii) In case of Deep Discount Bond, the issue price is always the face value.
(iv) Cash realized from sale of scrap is grouped under the category of cash from Investing activities in Cash flow statement.
(v) A brand is nothing but a glorified product name; hence it has no value.
(vi) The CAPM assumes perfect market competition.
(vii) In a synergistic merger, the post-merger value exceeds the sum of the separate companies' pre-merger values.
(viii) One of the consequences of Efficient Market Hypothesis (EMH) is that the market will always have equilibrium price of a company's share as determined by its fundamentals.

1.(b) The operating and cost data of ABC Ltd. are:
Sales ₹ 20,00,000
Variable Costs ₹ 14,00,000
Fixed Costs ₹ 4,00,000 (including 15% interest on ₹ 10,00,000)
You are required to:
(i) Calculate its operating, financial and combined leverage and
(ii) determine the additional sales to double its EBIT. **[6]**

1.(c) For Goal Ltd. the FCFE projected for next 3 years are stated below along with the immediately past year FCFE. You are required to value equity share by DCF approach. From Year 4 FCFE is expected to grow at 3% p.a. Cost of equity is measured at 15% p.a. Number of shares outstanding is 1,00,000. **[6]**

	Past Year	Projected		
		Year 1	Year 2	Year 3
FCFE(₹Lakhs)	160	180	200	220

Discounting Factor @ 15% p.a. Year 1= 0.869565, Year 2= 0.756144, Year 3= 0.657516.

2. The Balance Sheets of Maras Ltd. for the years ended on 31.03.2016 and 31.03.2017 are as follows: (Amount in ₹ Lakh)

	As at 31.03.16	As at 31.03.17
Equity & Liabilities		
Shareholder's Fund:		
Share capital	696.60	726.70
Equity Share suspense	30.07	------
Equity Share warrants	-----	841.20

Reserve & Surplus	31,256.89	39,156.40
Non-Current Liabilities:		
Secured Loans	4,784.56	3,300.09
Unsecured Loans	9,128.31	14,939.75
Deferred Tax liabilities	3,491.00	3,936.27
Current Liabilities:		
Other current liabilities	8,432.77	10,522.73
Provisions	856.44	1,496.31
	58,676.64	74,919.45
Assets		
Non-current assets	-------	------
Fixed Assets (Net)	31,830.23	30,941.81
Capital work in progress	3,764.07	11,502.92
Non-Current Investment:		
Investment	8,125.67	11,031.80
Current Assets:		
Inventories	6,068.25	7,123.77
Trade receivables	1,866.21	3,113.79
Cash and bank balance	917.68	2,140.03
Other current assets	1.53	36.27
Loans and advances	6,103.00	9,029.06
	58,676.64	74,919.45

Required:

(i) Prepare the Common-Size Balance Sheet of Maras Ltd.

(ii) Present and interpret your observations on the common-size Balance Sheet. **[6+10=16]**

3.(a) As credit manager of the bank, you have been approached by two companies for a loan of ₹ 1,00,000 for six months, with no collateral offered. Since the bank has almost exhausted its quota for loans of this type, only one of these requests can be granted. The relevant information supplied to you by the two companies is presented below:

Particulars	Company X (₹)	Company Y (₹)
Assets		
Cash	1,70,000	3,00,000
Sundry Debtors	2,74,000	4,24,000
Stock	9,00,000	13,50,000
Total Current Assets	13,44,000	20,74,000
Other Assets	10,00,000	10,20,000
	23,44,000	30,94,000
Liabilities & Capital		
Current Liabilities	5,00,000	6,40,000
Long-term Loans	8,00,000	10,00,000
Equity Share Capital	8,00,000	12,00,000
Retained Earnings	2,44,000	2,54,000
	23,44,000	30,94,000

Considering the above data specify the company which should be granted the credit. Explain your answer with reasons. **[10]**

(b) Following figures have been extracted from the records of Agni Ltd.

Year	2015-16	2016-17
Sales (₹)	2,60,000	3,60,000
Cost of Goods Sold (₹)	2,00,000	3,30,000
Gross Profit (₹)	60,000	30,000

It is learnt that cost price for the year 2016-17 has increased by 10% over the year 2015-16. Account for changes in gross profit in the year 2016-17. **[6]**

4.(a) What kind of conditions of a company are represented by the following pattern of cash flows? You are requested to provide your analysis of each case separately:

I. Net cash flows from Operating Activities are positive, net cash flows used in Investing Activities are negative and net cash flows from Financing Activities are positive.
II. Net cash flows from Operating Activities are negative, net cash flows used in Investing Activities are positive and net cash flows from Financing Activities are negative.
III. Net cash flows from Operating Activities are negative, net cash flows used in Investing Activities are negative and net cash flows from Financing Activities are positive.
IV. Net cash flows from Operating Activities are positive, net cash flows used in Investing Activities are negative and net cash flows from Financing Activities are negative.
V. Net cash flows from Operating Activities are negative, net cash flows used in Investing Activities are positive and net cash flows from Financing Activities are positive. **[2×5=10]**

(b) The following figures relate to two companies:

(₹ lakhs)

Particulars	T Ltd.	V Ltd.
Sales	500	1,000
Variable costs	200	275
Contribution	300	725
Fixed cost	150	425
Profit before Interest & Taxes (PBIT)	150	300
Interest	50	100
Profit before tax (PBT)	100	200

You are required to calculate - (A) operating, financial and combined leverages of the two companies, and (B) comment on the relative position of the companies in respect of the risk. **[3+3=6]**

5. Super Garments Ltd. is a company which produces and sells to retailers certain range of fashion clothing. They have made the following estimates of prudential cash flows for the next 10 years.

₹ in lakhs

Yr.	1	2	3	4	5	6	7	8	9	10
Cash flow	3,750	4,250	5,000	6,250	7,500	8,500	9,500	11,250	12,500	15,000

SONA Ltd. is a company which owns a series of boutiques in a certain locality. The boutiques buy clothes from various suppliers and retail them. Each boutique has a manager and an assistant but all purchasing and policy decisions are taken centrally. An independent cash flow estimate of SONA Ltd. was as follows:

₹ in lakhs

Yr.	1	2	3	4	5	6	7	8	9	10
Cash flow	300	400	500	700	850	1,150	1,300	1,500	1,650	2,000

SUPER Garments Ltd. is interested in acquiring SONA Ltd. in order to get some additional retail outlets. They make the following cost-benefit calculation;

i) Net Value of assets of SONA Ltd.

	₹ in lakhs
Sundry fixed assets	2,000
Investments	500
Stock	1,000
Total	3,500
Less: Sundry creditors	1,000
Net Assets	2,500

ii) Sundry fixed assets amounting to ₹1,25,00,000 cannot be used and their net realizable value is ₹1,12,50,000

iii) Stock can be realized immediately at ₹1,175 lakh

iv) Investments can be disposed off for ₹530 lakhs

v) Some workers of SONA Ltd. are to be retrenched for which estimated compensation is ₹325 lakh.

vi) Sundry creditors are to be discharged immediately

vii) Liabilities on account of retirement benefits not accounted for in the balance sheet by SONA Ld. Is ₹120 lakhs.

viii) Expected cash flows of the combined business will be as follows:

₹ in lakhs

Yr.	1	2	3	4	5	6	7	8	9	10
Cash flow	4,500	4,750	5,750	7,375	8,750	10,000	11,250	13,250	14,500	17,250

Find out the maximum value of SONA Ltd. which SUPER Garments Ltd. can quote. Also show the difference in valuation had there been no merger. Use 20% as discount factor.

Year	1	2	3	4	5	6	7	8	9	10
Discounting factor @20%	0.8333	0.6944	0.5787	0.4823	0.4019	0.3349	0.2791	0.2326	0.1938	0.1615

[16]

6.(a) Soft Solution is a small software firm with high growth rate. It has existing assets in which it has capital invested of ₹100 lakh. The other information about Soft solution is as follows:

The after tax operating Income on assets in place is ₹15 lakh. This return on capital of 15% is expected to be sustained in the future. Cost of capital of Soft Solution is 10%.
At the beginning of each of the next five years Soft Solution is expected to make new investments of ₹10 lakh each. These investments are also expected to earn 15% as a return on capital, and the cost of capital is expected to remain 10%.
After the year 5, Soft Solution will continue to make Investments, and earnings will grow 5% a year, but the new investments will have a return on capital of only 10%, which is also the cost of capital.
All assets and investments are expected to have infinite lives. The assets in place and the investments made in the first five years will make 15% a year in perpetuity, with no growth.
Based on the information given estimate the value of Soft Solution, How much of this value comes from the EVA and how much from capital invested? **[8]**

(b) Reliable Industries Ltd. (RIL) is considering a takeover of Sunflower Industries Ltd. (SIL). The particulars of two companies are given below

	RIL	SIL
Earnings After Tax (₹)	20,00,000	10,00,000
Equity shares (No.)	10,00,000	10,00,000
EPS (₹)	2	1
P/E Ratio (Times)	10	5

Required:

i) What is the market value of each company before merger?

ii) Assuming that the management of RIL estimates that the shareholders of SIL will accept an offer of one share of RIL for four shares of SIL. If there are no synergic effects, what is the market value of the post-merger RIL? What is the new price for

share? Are the shareholders of RIL better or worse off than they were before the merger?

Due to synergic effects, the management of RIL estimates that the earnings will increase by 20%. What is the new post-merger EPS and price per share? Will the shareholders be better off or worse off than before the merger? **[8]**

7.(a) Following are the information of two companies for the year ended 31st March, 2016:

Particulars	Company X	Company Y
Equity Shares of ₹10 each	20,00,000	25,00,000
10% Pref. Share of ₹10 each	15,00,000	10,00,000
Profit after tax	7,50,000	7,50,000

Assume the Market expectation is 18% and 80% of the Profits are distributed.

i) What is the rate you would pay to the Equity Shares of each company?

a) If you are buying a small lot.

b) If you are buying controlling interest shares

ii) If you plan to invest only in preference shares which company's preference shares would you prefer?

iii) Would your rates be different for buying small lot, if the company 'X' retains 30% and company 'Y' 10% of the profits? **[8]**

(b) ABC Ltd Company currently sells for ₹32.50 per share. In an attempt to determine if ABC Ltd is fairly priced, an analyst has assembled the following information.

- The before-tax required rates of return on ABC Ltd debt, preferred stock, and common stock are 7.0 percent, 6.8 percent, and 11.0 percent, respectively.
- The company's target capital structure is 30 percent debt, 20 percent preferred stock, and 50 percent common stock.
- The market value of the company's debt is ₹145 million and its preferred stock is valued at ₹65 million.
- ABC Ltd's FCFF for the year just ended is ₹ 28 million. FCFF is expected to grow at a constant rate of 4 percent for the foreseeable future.
- The tax rate is 35 percent.
- ABC Ltd has 8 million outstanding common shares.

What is ABC Ltd's estimated value per share? Is ABC Ltd's stock under priced? **[8]**

8. Write a short note on any four of the following: [4×4=16]

(a) Financial Modeling

(b) Distress Prediction

(c) Different Methods Of Valuing Self-Generated Brands

(d) Efficient Market Hypothesis

(e) Who are the participants in the Merger and Acquisition Process?