Paper-18: Business Valuation Management

Time Allowed: 3 Hours **Full Marks: 100**

The figures in the margin on the right side indicate full marks.

Working Notes should form part of the answer.

"Whenever necessary, suitable assumptions should be made and indicated in answer by the candidates."

Answer Question No. 1 which is compulsory carrying 25 marks and any five from the rest.

1. (a) State whether the following statements are true or false: [1x5=5]

(i) Under yield method of valuation of equity shares if the expected rate of return is less than the normal rate of return, the paid up value of shares increases proportionately.

(ii) Land and Building is an example of financial asset.

(iii) Firms with higher operating margins, lower reinvestment rates and lower costs of capital will trade at lower value – to - sales multiplies.

(iv) Market price of firms with high revenue ratios and low profit margins are considered by investors as overvalued.

(v) The intrinsic value of a share decreases after a bonus issue.

(b) Fill in the blanks by using the words/phrases given in the brackets: [1x10=10]

(i) While valuing the leasehold land of a company, one ……….. subject it to amortization (should/ should not).

(ii) The most appropriate method of determining the cost of equity for calculating the Weighted Average Cost of Capital is ……………….(The Dividend Discount Model/ The Capital Asset Pricing Model).

(iii) LIFO as a method of inventory valuation ………….allowed as per Indian Accounting Standards (Is/Is not).

(iv) A ratio between the market value of a company to the replacement value of its assets is known as ………..Ratio (Market Value to Book Value/ Market value to replacement value/Tobin's Q/ Price to book value).

(v) …………. Requires that the expected profit stream of an acquired business provides an attractive return on the total acquisition cost and on any new capital investment needed to sustain or expand the operations (The Cost of Entry test/Principle of Investment).

(vi) In valuing a firm, the …………tax rate should be applied to earning of every period (marginal/effective/average).

(vii) If a company's share is priced at ₹20 and EPS is ₹5, then P/E ratio will be ……. (0.25/4/400).

(viii) Dividend yield ratio is equal to dividend per share divided by…….. and the quotient multiplied by 100. (EPS/market price per equity share).

(ix) If EPS of a company is ₹15 and the P/E ratio of other similar company is ₹10, then market value of the share of this company will be ₹……….(150/1.5/.67).

(x) If firms defer taxes, the taxes paid in the current period will be at a rate …….than the marginal tax rate (lower/higher).

(c) In each of the questions given below one out of the four options is correct. Indicate the correct answer: [2×5=10]

(i) Estimated fair value of an asset is based on the ……………… value of operating cash flows.
(a) current
(b) discounted
(c) future
(d) none of these

(ii) A theory that explains why the total value from the combination resulted from a merger is greater than the sum of the value of the component companies operating independently is known as …………… theory.
(a) hubris
(b) agency
(c) operating
(d) synergy

(iii) A firm's current assets and current liabilities are 1600 and 1000 respectively. How much can it borrow on a short-term basis without reducing the current ratio below 1.25?
(a) ₹ 1,000
(b) ₹ 1,200
(c) ₹ 1,400
(d) ₹ 1,600

(iv) Identify which of the following is not a financial liability
(a) X Ltd. has 1 lakh ₹ 10 ordinary shares issued
(b) X Ltd. has 1 Lakh 8% ₹ 10 redeemable preference shares issued
(c) X Ltd. has ₹ 2,00,000 of 6% bonds issued
(d) Both (a) and (b)

(v) RICO LTD has PAT of ₹ 40.20 lakh with extra ordinary income of ₹ 7.00 lakh. If the cost of capital is 20% and the applicable tax rate is 40% the value of RICO LTD will be:
(a) ₹ 250 lakh
(b) ₹ 180 lakh
(c) ₹ 150 lakh
(d) Insufficient information

2. **(a)** Company X is contemplating the purchase of Company Y, Company X has 3,00,000 shares having a market price of ₹ 30 per share, while Company Y has 2,00,000 shares selling at ₹ 20 per share. The EPS are ₹ 4.00 and ₹ 2.25 for Company X and Y respectively. Managements of both companies are discussing two alternative proposals for exchange of shares as indicated below:

(i) in proportion to the relative earnings per share of two Companies.

(ii) 0.5 share of Company X for one share of company Y (0.5: 1).

You are required:

(i) to calculate the Earnings Per Share (EPS) after merger under two alternatives; and

(ii) to show the impact on EPS for the shareholders of two companies under both alternatives.

(b) Shyam Ltd. has announced issue of warrants on 1:1 basis for its equity share holders. The current price of the stock ₹10 and warrants are convertible at an exercise price of ₹11.71 per share. Warrants are detachable and are trading at ₹3. What is the minimum price of the warrant? What is the warrant premium? Now had the current price been ₹16.375, what is the minimum price and warrant premium? (Consider warrants are tradable at ₹9.75). **[(7+4)+4]**

3. **(a)** Calculate Economic Value Added (EVA) with the help of the following information Sun Limited.
Financial leverage: 1.4 times;
Equity capital ₹170 lakhs;
Reserve and surplus ₹ 130 lakhs;
10% debentures ₹400 lakh;
Cost of Equity: 17.5%
Income tax rate: 30%
Also explain the reason for the difference between the EVA and the MVA (Market Value Added).

(b) Sanju Ltd. gives the following information:

Current Profit	₹210 lakhs
Compound growth rate of profit	7.5%
Current cash flows from operations	₹270 lakhs
Compound growth rate of cash flows	6.5% p.a.
Current price earning ratio	12
Discount factor	15%

Find out the value of Sanju Ltd. taking 10 years projected profit or cash flows based on
(i) Discounted earning method,
(ii) Discounted cash flows method. **[6+9]**

4. Write Short Notes on *any three* **(5×3= Marks)**
(i) Reasons for mergers and acquisition.
(ii) Net realizable value of Inventories
(iii) Walter's valuation Model.
(iv) Fair Market value of Intangible assets
(v) Characteristic of Brand

5. (a) Following are the information of two companies for the year ended 31st March, 2013:

Particulars	Company X	Company Y
Equity Shares of ₹ 10 each	20,00,000	25,00,000
10% Pref. Shares 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?

(b) A Ltd. is considering the acquisition of B Ltd. with stock. Relevant financial information is given below.

Particulars	A Ltd.	B Ltd.
Present earnings	₹7.5 lakhs	₹2.5 lakhs
Equity (No. of shares)	4.0 lakhs	2.0 lakhs
EPS	₹ 1.875	₹ 1.25
P/E ratio	10	5

Answer the following question:

(i) What is the market price of each company?
(ii) What is the market capitalization of each company?
(iii) If the P/E of A Ltd. changes to 7.5, what is the market price of A Ltd?

(iv) Does market value of A Ltd. change?

(v) What would be the exchange ratio based on Market Price? (Take revised Price of A Ltd.) **[(4+3+3)+(1×5)]**

6. (a) What is Human Resource Accounting? What are its benefits? State the two main methods of its measurement.

(b) Assume the current market value of the bidding company is ₹40 crores, and that of the target company is also ₹40 crores. Then, the sum of the values as independent companies is ₹ 80 crores. Suppose, as a combined entity, due to synergistic effects, the value increases to ₹ 100 crores. The amount of value created is ₹ 20 crores. How will the increase in value be shared or divided between the bidder and the target company?

(c) Print plus Publishers Ltd. has been approached by another publisher Welldone Ltd. which is interested in buying the copyright of the book 'Portfolio Management'

To estimate the value of the following assumptions are made:

(i) The book is to generate ₹ 1,50,000 in after-tax cash flows each year for the next three years and ₹ 1,00,000 a year for the subsequent two years. These are the flows after payment of author royalties, promotional expenses and production costs.

(ii) About 40% of these cash flows are from large organizations that place bulk orders and considered predictable and stable. The cost of capital applied to these cash flows is 7%.

(iii) The remaining 60% of the cash flows are to the general public and this segment of the cash flows are to the general public and this segment of the cash flows is considered much more volatile. The cost of capital applied to these cash flows is 10%.

Based on the information given above, estimate the value of the copyright.

[(2+2+2)+3+6]

7. (a) Given below is the Balance Sheet of MNC Ltd as on 31.03.2013 (₹ Lakhs)

Liabilities	₹	Assets	₹
Share Capital	100.00	Sundry Fixed	144.00
Reserve	64.00	Non- Trade Investments	24.00
Profit and Loss Account	6.00	Stock	15.60
Sundry Creditors	16.40	Debtors	12.40
Proposed Dividend	20.00	Cash & Bank	10.40
Total	206.40	Total	206.40

Other Information:

(i) Profit Before Tax and Other relevant information: (₹ Lakhs)

Year	Profit Before	Provision for Gratuity required	Gratuity Paid	Loss of uninsured

	Tax			stock
2009	84.00	4.40	-	-
2010	78.00	4.60	3.34	1.24
2011	88.00	5.00	0.64	-
2012	84.00	5.20	2.84	-
2013	74.00	5.40	0.24	-

(ii) Post Tax Rate is 51% while Expected Tax Rate is 45%.

(iii) The Company wants to switch over towards maintaining gratuity provision on actuarial calculation rather than accounting on payment basis. The Company's Non-Trade Investments fetched 11%.

Find out value of Goodwill. It may be assumed that Super Profit, if any, is maintainable for 5 years. 18% should be the appropriate discount factor. Normal Rate of Return may be taken as 15%.

(b) Explain the investment implications of the efficient market theory? **[10+5]**

8. X Ltd and Y Ltd , two private Companies, decide to amalgamate their business into a new Holding Company Z Ltd ., which was incorporated on 1st Nov 2012 with an Authorized Capital of ₹40,00,000 in Equity Share of ₹10 each. The new Company plans to commence operation on 1st Jan 2013.

From the information given below, and assuming that all transactions are completed by 30th June 2013, you are required to –

Show the computation of the number of shares to be issued to the former shareholders of X Ltd & Y Ltd.

Calculate the Cash Flow available to Z Ltd. based on the information available to you.

Information

(i) Z Ltd will acquire the whole of Equity Share Capital of X Ltd and Y Ltd by issuing its own shares fully paid.

(ii) The number of shares to be issued is to be calculated by multiplying the future annual maintainable profits available to the Equity Shareholders in each of the two Companies by the agreed Price Earning Ratios.

(iii) The following information is relevant.

Particulars	X Ltd	Y Ltd
Equity Shares of ₹10 each fully paid	10,00,000	4,00,000
8% Cumulative Preference Shares	-	1,00,000
10% Debentures	2,00,000	-

Future annual maintainable pre-tax profits (before interest/ dividends)	2,30,000	1,12,000
Price Earning Ratio	10 times	8 times

(iv) Shares in the Holding Company are to be issued to the shareholders in Subsidiary Companies at a premium of 20% and thereafter these shares will be marketed on the Stock Exchange.

(v) It is expected that the Group Profits of the new Company in 2013 will be at least ₹4,50,000 but that will be required as additional Working Capital to facilitate expansion. Accordingly, it is planned to make a further issue of 37,500 Equity shares to the public for Cash at a premium of 30% on 1st May 2013. The new shares will not rank for interest / dividend to be paid on 30th June 2013.

(vi) Out of the proceeds of the Public Issue, Z Ltd will advance ₹2,50,000 to X Ltd and ₹2,00,000 to Y Ltd on 1st May 2013 for Working Capital. These advances will carry interest @ 15% p.a to be paid monthly.

(vii) Preliminary Expenses are estimated at ₹8,000 and Administrative Expenses for the half-year ended 30th June 2013 at ₹16,000 but this expenditure will be covered by temporary overdraft facility. It is estimated that Bank Overdraft cost will be ₹1,600 in the first six months.

(viii) A provision for ₹7,500 should be made for Directors Fee for the half year.

(ix) On 30th June 2013, it is planned to pay interim dividend as: Per share X Ltd – 5% , Y Ltd - 4.40%, Z Ltd - 4%

(x) Income tax 50%. (Say) **[15]**