Paper 20: Financial Analysis & Business Valuation

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

Group-A

(Answer Question 1 and 2 which are compulsory and any two from the rest)

Question 1

Torrent Power Limited
Cash Flow Statement
For the year ended 31st March, 2011

Particulars	Year ended 31st March, 2011	Year ended 31st March, 2010
Cash Flow from operating Activities		
Net Profit before tax	1,428.82	1,186.45
Adjustments for:		
Depreciation	392.68	335.35
Excess provision written back	(195.64)	(1.71)
Interest expenses	338.90	314.06
Loss on Sale/Redemption of investments	-	0.01
Loss on sale of fixed assets	8.24	9.83
Profit on sale of fixed assets	(0.21)	(0.35)
Provision for Bad Debt	65.41	6.81
Dividend/ Interest	(73.80)	(42.85)
Operating Profit before Working capital changes	**1,964.40**	**1,807.60**
Adjustments for:		
Trade and other receivables	(160.59)	(116.72)
Inventories	(119.40)	23.91
Current Liabilities and Provisions	229.81	109.03
Service Line and Security Deposits	41.87	69.38
Cash generated from operations	**1,956.09**	**1,893.20**
Taxes Paid	(248.01)	(227.35)
Net cash Flow from operating Activities	**1,708.08**	**1,665.85**
Cash Flow investing Activities		
Purchase of fixed assets including capital work-in-progress	(865.40)	(560.49)
Sales of fixed assets	3.56	2.48
Purchase of investments	(677.45)	(32.24)
Sale of investments	5.05	0.05
Dividend and Interest received	73.86	42.85
Net Cash used in Investing Activities	**(1,460.38)**	**(547.35)**
Cash Flow from Financing Activities		
Long term borrowings	100.00	386.90
Short Term borrowings	185.96	-
Repayment of fixed deposits	*	(0.01)
Repayment of borrowings	(414.80)	(446.28
Repayment of APDRP Loan	(2.95)	(1.64)
Service Line Contribution	86.55	55.09
APDRP Grant	-	16.41

Dividend paid	(164.49)	(109.94)
Interest paid	(347.66)	(320.15)
Net Cash used in Financing Activities	**(557.39)**	**(419.62)**
Net (decrease) / increase in cash and cash Equivalents	**(309.69)**	**698.88**
Cash and Cash Equivalents as at beginning of the year	**1,339.37**	**640.49**
Cash and Cash Equivalents as at end of the year	**1,029.68**	**1,339.37**

Notes:

1. Cash and Cash Equivalents as at end of the year:

	31st March, 2011	31st March, 2010
Cash and bank balances	926.27	1,171.43
Current Investments (Investments in Mutual Funds)	103.41	167.94
Total	1,029.68	1,339.37

2. The Cash Flow statement has been prepared under the 'Indirect method' set out in Accounting Standard 3 "Cash Flow statement" issued by The Institute of Chartered Accountants of India.
3. Interest paid is exclusive of and purchase of Fixed Assets is inclusive of interest capitalized ₹12.98 crores (previous year ₹56.94 crores).

After reading the above case thoroughly, answer the following questions:

(a) What will be the impact on financing activities if the long term borrowings amounted to ₹120.00 crores instead of ₹100.00 crores in the year 2010-11?

(b) How Free Cash Flow is calculated? In the present case, if it is assumed that the current investments are made out of cash, what will be the free cash flow?

(c) How cash from operation is calculated as per direct method?

(d) Why interest expenses are added back to Net Profit before Tax? In what manner tax benefit can be gained on interest expenses?

(e) Although Torrent Power Ltd. has no non-cash transaction but what will the treatment if it has?

[3+4+3+3+2]

Question 2

Proxy Casting Limited (PCL) had been doing excellent business for the last four years. It share value had increased four times in four years, from ₹25 to ₹100, providing returns much beyond the expectations of shareholders and management. The earnings level had jumped by about 25%. The shareholders had seen about 100% rises over the last year due to enhanced earning and re-rating of the company on the market. The price of the share was hovering around ₹100 in early March 2014 when the market was expecting an earning level of ₹23 crore and an EPS of ₹8.32. The performance of the firm for the last year and the current year, on the verge of completion, is presented in Table A.

Table A Select financial data-Proxy Casting Limited (₹ lakh)

	March 2013	**March 2014 Estimated**

EBIT	1,850	2,300
Interest	1,000	1,000
EBT	850	1,300
Taxes	306	468
EAT	544	832
Nos. of Shares (lakh)	100.00	100.00
EPS (₹/share)	5.44	8.32
PE Multiple	10.00	12.10
Price (₹/share)	54.40	100.67
Value of Equity (₹ lakh)	5,440	10,067

Buoyed by the excellent returns, the promoters of the firm assumed an aggressive stand, and were on a shopping spree for enhancing business. They were then operating at about 80% capacity utilization, and had an order book that would require production in excess of 100% capacity. They seemed to have no choice but to go for inorganic growth. Ravi Prakash (RP), the Managing Director, and his younger sibling Kavi Prakash (KP), the Dy. Managing Director, who held about 40% of the equity, were negotiating with the neighbouring First Casting Limited (FCL), a closely held company that was almost three-fourth of the size of PCL. The promoters of FCL were demanding ₹100 crore. Both the brothers thought it to be an excellent bargain, and were very keen to acquire the firm in view of promising business opportunities and the scope for enhancing their capacity, something that was needed to fulfill the orders expected in the near future.

The need for acquisition was well established, but the question of funding it was a lingering issue. The firm had always believed in the philosophy of maintaining a reasonable level of debt and equity while funding growth and business operations. KP always believed in an equal proportion of equity and debt. According to him, there could not be a finer or better balance between the two sources of funding. Their philosophy had been to pay earnings in dividend after retaining the funds required for growth, based on a debt-equity ratio of 1:1. There were no administrative or fundamental hurdles from the banks and financial institutions providing the loans. The plan was to retain only half as much money as required for growth and distribute the remaining as dividend, and thus, PCL had no ready cash available that could be used for acquisition. The elder brother was indifferent to financing questions, as he concentrated more on technical, marketing, and operational aspects.

Faced with an inadequate cash balance, mobilizing funds to the extent of ₹100 crore for the acquisition posed a major challenge. They passed on the task of finding the requisite funds, and more importantly the policy for funding, to their long-time associate and trusted Vice President Finance, Kevin Xavier (KX).

After considerable discussion regarding the expected level of earning after the acquisition of FCL, the management was convinced that EBIT would jump to about ₹35 crore from the current level of ₹23 crore. After lot of thought and lengthy deliberations with bankers, KX had three possible alternatives before him for funding the acquisition. These were:

All equity option One option was to fund the entire ₹100 crores by way of equity. This was possible by placing the shares privately with the institutional investors for the required ₹100 crore. Considering the market capitalization of ₹100 crore for the existing equity, it was indeed a difficult task. However, discussions with some private investors who looked for promising returns and not for management control had assured him that the placing of equity of an amount equivalent to the current market capitalization was possible provided the shares were offered at a discount of a minimum of 5% on the current market price. About 105 lakh additional shares would be needed, at ₹95 per share.

Debt and equity in equal proportions Another alternative was to continue with the existing funding philosophy of PCL: equal amounts of equity and debt Assuming the same market conditions, KX believed that private investors would have no problems in subscribing ₹50 wore at ₹95 per share. Apart from issuing about 63 lakh additional shares, KX had to mobilize an equivalent amount by way of loans. Given PCL's excellent track record with lenders and its promising future, the existing lenders would gladly provide the required ₹ 50 crore.

All debt option Although this option was not initially in the scheme, KX thought of it when his talks with the banks revealed that they were not averse to accepting a debt-equity ratio of 2:1. As such, the funds could be made available by the existing lenders, or syndicated by them. KX was more than pleased to hear such commendations from his lenders. KX presented an analysis of the three alternatives, as shown in

Table B Comparison of financing schemes **(₹ Lakh)**

Projected	All equity	Equal	All Debt
Funds required	10,000	10,000	10,000
Fresh equity	10,000	5,000	—
No. of fresh shares (lakh)	105.26	52.63	—
Debt issued	—	5,000	10,000
Interest rate	10%	10%	10%
Additional interest cost	—	500	1,000
EBIT	3,500	3,500	3,500
Interest	1,000	1,500	2,000
EBT	2,500	2,000	1,500
Taxes	900	720	540
EAT	1,600	1,280	960
No. of shares (lakh)	205.26	152.63	100.00
EPS (₹/share)	7.79	8.39	9.60
Expected PE multiple	15.00	12.00	9.00
Expected price (₹/share)	116.92	100.63	86.40
Value of equity (₹ lakh)	24,000	15,360	8,640

Read the above case carefully and answer the following questions:

(a) Analyse the implications of the three financial options.

(b) Find out the financial leverage for the above three plans and comment on it.

(c) If 30% of the total fund requirement is financed by debt, then what will be the EBIT (Earnings before interest and tax), EBT (Earnings before tax) and EPS (Earnings per share)?

[9+3+3]

Question 3

From the following information of Rajarshi Ltd. for the years that ended on 31st march, 2012 and 31st march, 2013, find out the cost of goods sold for both of the years, prepare a Comparative Income Statement and comment on the financial performance of the company.

	2011-12 (₹)	2012-13 (₹)
Gross sales	4,80,000	5,27,000
Sales return	27,000	12,000
Purchases made during the year	3,25,000	3,45,000
Opening stock	53,000	62,000
Closing stock	11,000	13,000
Direct wages paid	500	700
Administrative expenses	17,000	23,000

Selling & distribution expenses	33,000	24,000
Interest paid	8,000	10,000
Tax paid	14,000	19,000

[10]

Question 4

(a) From the following informations and particulars of Zed Ltd. for the year ended 31.03.2013 calculate — (1) Book Value per Share, (2) Earnings per Share, (3) Dividend Yield, (4) Earning Yield, (5) P/E Ratio and (6) P/B Ratio.

The informations which are available from the Books of Accounts of Zed Ltd. are as follows: (All ₹ in lakhs)
Sales — ₹16.34, Cost of goods sold — ₹10.25, Administrative expenses — ₹0.46, Selling and distribution expenses — ₹1.47, Depreciation — ₹1.05, Interest on debt — ₹1.13, Tax provision — ₹1.08, Proposed dividend — ₹0.90, Equity share capital (consisting of 7,000 equity shares of ₹100 each) ₹7.00, Reserve & surplus — ₹1.15, 8% Debentures — ₹9.0, 9% Public deposits — ₹3.4, Trade creditors — ₹3.28, Outstanding liabilities for expenses — ₹0.23, and Fixed assets (less accumulated depreciation for ₹4.6) ₹15.6.

Monthly average market price per share during month of March, 2013 was ₹247.
Industry averages: P/E ratio 10, P/B 1.6, Dividend yield 8%.

(b) What is Capital Employed? What is the significance to find out the ratios related to capital employed?

[6+4]

Question 5

(a) "There are a number of factors responsible for Corporate Distress/Sickness. These factors may be classified into two parts, namely, internal factors and external factors." — Write down the causes of corporate distress from both the internal and the external perspectives.

(b) Write a short note on Market Related Off-Balance Sheet Items.

[6+4]

Section B – Business Valuation

(Full Marks: 50)

Answer Question no.6 and 7 and any two from the rest in this section.

Question 6

X Ltd is a firm which in order to increase its market share is considering the proposal to acquire Y Ltd, which is considered as a very promising prospect due to its excellent R&D team. If X Ltd acquires Y Ltd, it will be a backward integration for X Ltd, a manufacturer, with R&D firm and is likely to drive significantly the growth rate of X Ltd that has been presently languishing at 11-12%. If the acquisition takes place the cash flows are projected to grow @ 25% per annum post-acquisition for the next five years, after which, cash flow of the

combined firm are expected to grow at a rate of 9% per annum, which is the expected growth rate of economy.
The projected post-tax cash flows for X Ltd for the next five years (without acquisition) are as follows:

(₹ in lakhs)

Year	Cash Flow
1	500.00
2	557.50
3	621.61
4	693.10
5	772.80

If the acquisition takes place the expected cash flows (after tax) of the combined firm (X')* are projected as:

(₹ in lakhs)

Year	Cash Flows
1	637.00
2	796.25
3	995.31
4	1244.14
5	1555.18

The acquired rate of return for the firms that have risk-return characteristics similar to X Ltd is 14%. The number of equity shares outstanding in X Ltd are 2,00,000 while those in Y Ltd are 1,00,000. If the acquisition takes place, the exchange ratio is likely to be 0.5 in the combined firm for the shareholders of Y Ltd. What is the expected NPV for X Ltd from acquisition?

[15]

Question 7

Last year, Mr. Amit was engaged as a consultant to the Expert Electricals and prepared some analysis of its cost-volume –profit-relationships. Among his findings was that the profit volume ratio was 40% at the firm's planned selling price of ₹ 50. The firm expected to sell 8,000 units, at the price of ₹ 50, which would result in an income of ₹96,000. Amit stressed the point in his report to the chief executive of the Company that profits would change at the rate of Re. 0-40 per rupee change in sales. The chief executive called Amit to tell him that the result did not come out as were told to him. The firm earned profits of ₹ 1,26,400 on sales volume of ₹4,53,600. Although variable costs per unit were incurred at expected, the firm had higher fixed costs than expected because of a ₹ 4,000 advertising campaign during the year. The campaign was coupled with an increase in selling price and the chief executive was very pleased with the results. However, Amit is asked to explain why profits did not increase by 40% of the added sales volume of ₹53,600 but rather somewhat more.

You are required to do the following:

(i) Reconstruct the income statement for the year based on the actual results.

(ii) Determine (a) the number of units sold and (b) the selling price per unit.

(iii) Explain to the chief executive why the results were at variance with the planned.

[6+4+5=15]

Question 8.

SDN Corporation acquired Swat's Ltd. business on 31-3-2010 for ₹5,000 lakhs. The details of acquisition are as under:-

Fair value of identifiable asset	4,000 lakhs
Goodwill (to be amortised in 5 years)	1,000 lakhs

The anticipated useful life of acquired assets is 8 years. SDN Corporation uses straight-line method of depreciation with no residual values is anticipated. On 31-3-2012 SDN Corporation estimated the significant decline in production due to changed Government policies, the net selling price of identifiable asset is not determinable. The cash flow forecast based on recent financial budget for next 6 years after considering changed Govt. policies are as follows, incremental financing cost is 10% which represent current market assessment of the time value of money.

(₹ in lakhs)

Year	**Cash Flow**
2013	700
2014	700
2015	700
2016	500
2017	500
2018	500

Acquired business is a cash-generating unit required:-

(a) Value in use

(b) Impairment loss

(c) Revised carrying amount assets on 31-3-2012 **[4+3+3=10]**

Question 9

(a) Discuss the major aspects, assumptions and decision rules of the discounted cash flow model.

(b) Why are sector specific multiples used by analysts? **[5+5=10]**

Question 10

X Ltd gives the following information about production and sales:

Month	**Production Units**	**Cost ₹**	**Sales Units**
July '12	10,000	25,000	8,000
August '12	15,000	38,500	12,500
September '12	27,000	66,200	24,500

Costs include raw material, wages and direct expenses. Variable production overhead was 20% of prime cost (Pre-determined rate) and monthly fixed overhead was ₹ 14,000.

Find out the value of inventory assuming that either there is no under-or-over –recovery or any under-or-over-recovery is transferred to profit and loss account directly.

[10]