

Business Finance.
Practice Questions.

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Q.17 D) IRR is not reliable. means of choosing between mutually exclusive projects.

Q.27 A) Market Price of Share / Earnings per Share

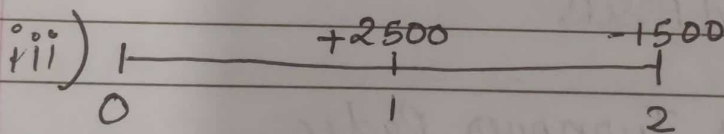
Q.37 D) All of the above.

Q.47 D) 10,00,000.

Q.57 Sales $\rightarrow 2500$ (+ve C.F) Costs $\rightarrow 1500$ (-ve C.F)
i) C.F at date 1 = $+2500 - 1500 = +ve 1000$.

ii) $NPV = \text{Net Cash Flow} \times \text{Discounting Factor}$

$$1000 \times \left(\frac{1}{1.2} \right) = \frac{1000}{1.2} = 833.33 = NPV.$$



$$NPV_2 = \frac{2500}{1.2} + \frac{(-1500)}{(1.2)^2} = 2083 - 1041.667 = 1041.667.$$

NPV increases in comparison

8.67 For business efficiency, one can use;

→ Inventory Turn Over ratio.

It measures the company's ability to manage its inventory efficiently and provides insight into the sales of company.

$$= \frac{\text{Cost of Goods Sold}}{\text{Inventory}}$$

→ Asset Turnover Ratio

It measures the company's ability to ~~measure~~ efficiently generate revenues from its assets.

$$= \frac{\text{Revenue}}{\text{Total fixed Assets}}$$

→ Receivables Turnover Ratio

Ratio of how actively collect its debts and extend its credits.

$$= \frac{\text{Revenue}}{\text{Total Assets}}$$

8.7 Limitations to Ratio Analysis.

- Ratio Analysis is Historic (Not Current).
- It does not take external factors into account such as world recession.
- It does not measure the human element of a firm.
- They can be used only to compare the firms of same size and type.

8.9) c) In general

8.8] i). Beta, indicates how volatile a stock's price is in comparison to overall stock market.

- Beta > 1 indicates more effect on the stock price due to the economic than the
- Beta being greater indicates a stock's price is more volatile than the overall market.
- Volatility is the degree to which a stock's price changes in relation through to overall market.

$$\textcircled{8} \quad \text{ii) } \beta_{\text{geared}} = \beta_{\text{ungeared}} \cdot \left[1 + \frac{D}{E} (1 - t) \right]$$

$$= 1.1 = \beta_{\text{ungeared}} \cdot \left[1 + \frac{1}{2} (1 - 0.3) \right]$$

$$= \beta_{\text{ungeared}} = 0.81481$$

$$\text{When } \frac{D}{E} = \frac{1}{1}$$

$$\beta_{\text{geared}} = \beta_{\text{ungeared}} \left[1 + \frac{1}{1} (1 - 30\%) \right]$$

$$= (0.81481) \times [1 + 0.7]$$

$$\beta_{\text{geared}} = 1.385185$$

Q.97 B) In general, ^{market} value of investment trust is higher than the net present value.

Q.107 When the business managers try to maximise the wealth of their firm, they are actually trying to increase the company's stock price. Valuation of the firm depends on the stock price.

Some of the problems associated with demonstrating that companies actually do operate in such a way as to maximize the shareholder's wealth.

- (i) Conflicts between Owners and Manager
- (ii) Sustainability of long term goals
- (iii) Quality of Product.

Part - 2] after 11

8.11) Beta coefficient / Beta refers to the volatility of a stock's price in comparison to overall stock market.

$$\beta = \frac{\text{Covariance}(R_e, R_m)}{\text{Variance}(R_m)}$$

$R_e \rightarrow$ Return on individual stock.

$R_m \rightarrow$ Return on overall market.

ii) It is the systematic risk of a security compared to market as a whole. It is mostly used in the capital asset pricing model [CAPM].

iii) A beta of '-1' indicates that the stock is behaving completely opposite of its expectation.

A beta of '+1' indicates that the security stock's price is more volatile than the market. As an investment investor, I would ~~invest~~ invest in ~~XXXX~~ Stocks with high Beta.

iv) A Beta of '0' indicates that there is no systematic risk.

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8.10Y ii)

$$DPS = 10$$

$$\text{Growth} = 8\%$$

$$MPS = 70$$

$$a) \beta = 1$$

$$\text{Cost of Equity} = \text{Exp DY} + \text{Growth}$$

$$RE = \frac{10}{70} + 8\% = 22.2857\%$$

$$RE = 6\% + 5\% \times \beta$$

$$\beta = \frac{16.2856}{5}$$

$$\beta = 3.25714$$

$$\text{New } \beta = \text{old} + 80\% \text{ of Old}$$

$$= 5.86285$$

$$\text{New } RE = 6\% + (5\% \text{ of } 5.86235)$$

$$= 35.31426\%$$

$$RE = 35.31426 = \left(\frac{10}{MPS} \times 100 \right) + 8\%$$

$$\frac{10 \times 100 \times 100}{MPS} = 27.81426$$

$$\text{New } MPS = \frac{1000}{27.81426} = 36.6109$$

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Q.14) Current Ratio is used to evaluate a company's ability to pay its short term obligation such as accounts payable, etc.

$CR < 1$ shows the company being unable to pay its short term liabilities.

Debtors Turnover Period.

It measures how effectively a company is able to collect its debt.

Higher the DBT indicates higher/better liquidity.

ii) Xylo Ltd. will use current ratio to meet its short term liabilities.

Current ratio refers to the ability of the company to pay short term credit.

8.15/1) $D:E = 1:1$ | Div Yield
 $GRY = 8\%$

A manageable $D:E$ ratio always provides a good dividend yield.

$$WACC = NCD \times \frac{D}{D+E} + R_E \times \frac{E}{D+E}$$

$$= \left(8\% \times \frac{1}{2} \right) + \left(4\% \times \frac{1}{2} \right) = 6\%$$

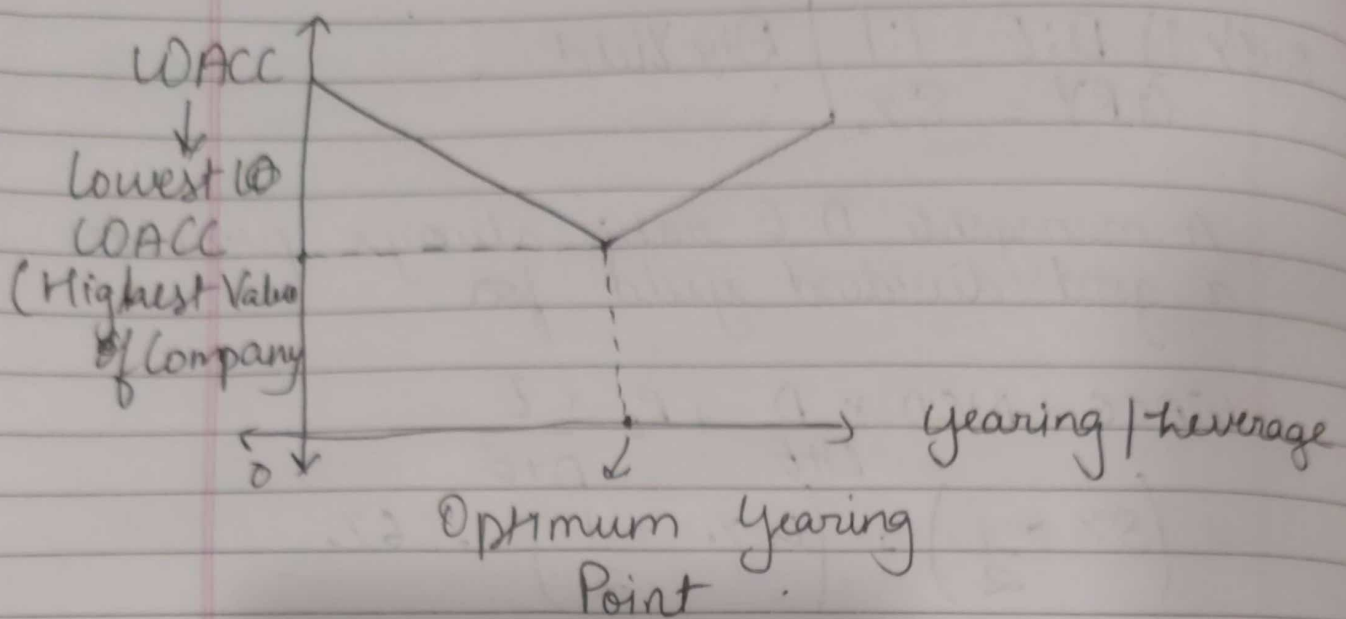
$COC = 6\%$ assuming growth percentage not considered. No Taxation

ii) Generally cost of ^{debt} ~~equity~~ is cheaper than cost of equity.

→ To ~~increase~~ ^{reduce} the WACC, the manager will try to increase the weight of debt, which will increase the valuation of the company.

→ But in doing so, the existing shareholders will feel more at risk, and their need for a higher return will increase too.

→ Thus, ~~in~~ initially the debt WACC will reduce as the debt increases, that is till a certain point of leverage, beyond that the WACC will increase



~~(iv)~~ iii) M & M's first irrelevance proposition states that the valuation of company is independent of its capital structure, as its based on investing decisions.

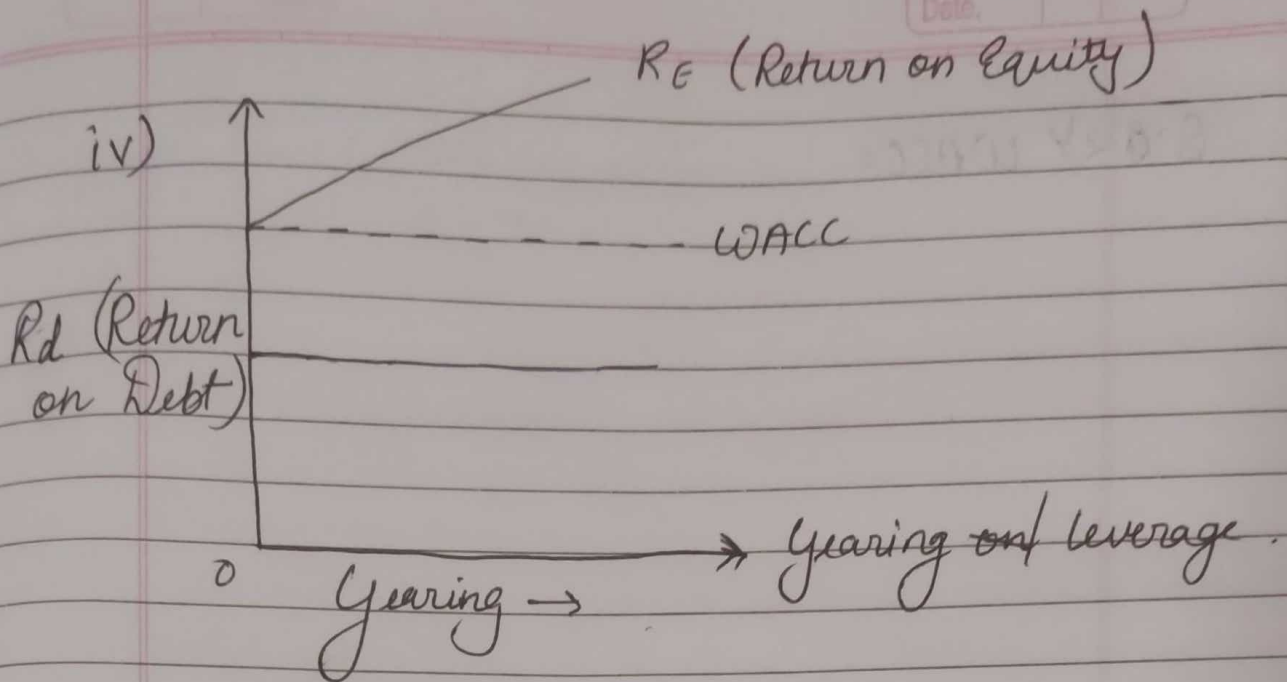
Assumptions:

perfect information

irrelevant capital structure

No Tax on debt

No Agency Cost



v) a) Assumption: - $\beta_{\text{geared}} = \beta_{\text{ungeared}} = 1.4$
as there is insufficient information.

$$R_E = R_f + ERP \times \beta = 6\% (6\% \times 1.4) = 13\% \quad R_E$$

b) Total Market = 100 Mn $\rightarrow$ Debt = 50%.
Equity = 50%.

$$D:E = 1:1, \quad \text{tax} = 30\%$$

$$\beta_{\text{geared}} = \beta_{\text{ungeared}} \times \left(1 + \frac{D}{E} (1 - t) \right)$$

$$= 1.4 \times \left(1 + \frac{1}{1} (1 - 0.3) \right)$$

$$= 1.4 \times 1.70$$

$$= 2.38 \rightarrow \beta_{\text{geared}}$$

$$R_E = R_f + MRP \times \beta_{\text{geared}}$$

$$= 6\% + (5\% \times 2.38)$$

$$R_E = 17.9\%$$