FIN722 Final term Subjective Solved Mega file

Question No: 63 (Marks: 3)

What is bond Future? How it is priced?

Bond futures: these are based on standard quantity of notional bonds. If buyer or seller does not close his position before the final settlement date, then the contract is settled through physical delivery.

Prices of interest rate future are determined as follows:

Bond futures: these are priced exactly the same way as normal bonds.

For example, an interest rate future may be priced at 109.50 per 100 nominal value of underlying notional bonds.

Question No: 65 (Marks: 3)

Which method is best for acquiring the assets of Target Company?

Asset or Share Purchase there's a difference between acquisition through assets purchase and share purchase methods.

Under asset purchase method, the purchaser only buys asset of the target company at negotiated prices without assuming any liability.

An assets purchase will enable the predator company to claim some tax related allowances on assets acquired. The target will have some adverse tax issues relating to the disposal of assets, which is normally higher than the book value.

A share purchase is more complex because of the fact that predator has to own the liabilities as well. The administration and documentation is much more complicated and lengthy coupled with the consultancy costs.

There is a technique called hive down which can reduce the risks and disadvantages of share purchase method. This is applied when only part of the business is being taken over by the purchaser. The part is transferred to a new entity of the vendor without raising any tax adverse consequences.

Question No: 67 (Marks: 5)

A Company had the following data, extracted from its financial statements for the year ending June 30, 2008:

a) Current Ratio = 2
b) Acid Ratio = 1.5
c) Current Liabilities = $500,000
d) Inventory Turnover = 5
e) Gross Profit Margin = 20 percent

What were its sales for the year?

Current ratio = current asset / current liabilities
2 = current asset / 500,000
Current asset = 1000,000

Acid Ratio = (current asset – inventory) / current liabilities
1.5 = (1000, 000 – inventory) / 500,000
Inventory = 250,000

Inventory Turnover = CGS / inventory
5 = CGS / 250,000
CGS = 1250,000

Sales 100% 1562,500 (1250, 000/0.8)
CGS 80% 1250,000

GP 20%

Question No: 44 (Marks: 3)

Give at least three reasons of merger failure and explain each of them briefly.

Human integration

Lack of involvement by human resources can have a detrimental impact on the merger, since it means that many issues that are directly linked to the success or failure of the merger will have been overlooked.

Corporate culture

Even if two companies seem to have the entire right ingredient in place for a successful merger, cultural differences can break the deal.

Lack of communications:

Poor communication between people at all levels of the organization, and between the two organizations that are merging, is one of the principal reasons why mergers fail.

If a firm is facing cash flow problems, what steps would you suggest to the firm to overcome its cash flow problems?5 marks

Cash flow problems can be handled in the following ways:

- decreasing the receipt float
- deferring capital expenditure (capex) and developmental work
- accelerating cash inflows which were set for recovery at a later period
- liquidating investments
- deferring payments to creditors
- rescheduling loan payments
- planning is of immense importance especially rolling cash budgets.

How a firm can create a hedge against interest rate risk? Explain briefly. 5 marks

A firm can create a hedge against interest rate risk through following ways:

- *Forward Rate Agreements – FRA*
  This is a contract and a financial instrument that is used has hedge against interest rate adverse fluctuations on deposit or loans starting in near future.
  This resembles to forward exchange rate agreements to fix the exchange rates.
- *Interest Rate Future:*
  Hedging with Short Term Interest Rates:
  A company intends to borrow short term in future may be concerned about the rising short-term interest rates.
  The hedge is to establish a notional position to fix the interest rate in short term.
- *Interest Rate Options*
  An interest rate option is an option to borrow or lend "Notional" amount for a specified period starting on or before a future date (expiry date) at a fixed rate of interest (exercise price).
- *Interest Rate SWAPS*
  A Swap is a contract where one party exchanges the interest stream for another party's stream.

Suppose a firm is planning to borrow some amount in a short-term period. How this firm can create a hedge against rising interest rates? 5 marks

A company intends to borrow short term in future may be concerned about the rising short-term interest rates.
The hedge is to establish a notional position to fix the interest rate in short term.

Differentiate between the Forward Contract and Currency Future. 5 marks

Forward contract vs. Currency future

In currency futures, commodity exchanges are involved and credit risk is eliminated. However, a forward contract is made between parties and each party needs to confirm the credit worthiness of each other.

Reversal of currency future is very simple. Large buyers and sellers exist. Reversing forward contract is difficult. Original parties have to set off the deal. Future currency contract become a “commodity” and reversing does not require original parties.
Size of contract: no size restriction is placed in forward contract and is up to parties to deal or contract in the magnitude they like. However, in future currency contract the size is pre-determined or fixed. In this scenario, perfect hedge is not possible.
In forward contract, no margin is required but in currency future parties have to put an initial margin.

How Short-Term Interest rate future are Priced? Explain With help of Some Examples? (3 Marks)
Interest rate futures are also contracts, which have following features:

- These contracts are similar to currency futures.
- These are traded in standardized form on future exchanges.
- Settlement dates on future exchanges are calendar quarters.
- Each future contract is for standardized quantity of underlying security.
- Price of the future is expressed in terms of underlying item.
- Interest rate future, like currency futures may be settled before the maturity date.
- Short Term Interest Rate futures – STIRs are cash settled

Enlist the Anti-Takeover Measure to be taken by a Target Company to resist a Takeover Bid of the Predator Company. (3 Marks)

- Poison pill
- Pac-Man
- White knight (business)
- Disposal of Key Assets
- Acquisition by the Target
- Politics

Question No: 46 (Marks: 5)
How are dividends paid and how do companies decide on dividend payments?
How dividends are paid out depends on the type of stock and the company's policies. Preferred stocks have guaranteed fixed-rate dividends. Some preferred stock issues may also earn additional dividends if the company's earnings are good. Common stocks may or may not pay dividends, and may be in the form of cash or stock dividends. Many investors also choose to enroll in a dividend reinvestment plan (DRIP) that uses any cash dividends to purchase additional shares of stock.

OR

Should the company decide to follow either the high or low dividend method, it would use one of three main approaches: residual, stability, or a hybrid compromise between the two.
If a company decides to pay dividends, it will choose one of three approaches: residual, stability or hybrid policies. Which a company chooses can determine how profitable its dividend payments will be for investors - and how stable the income.

Question No: 47 (Marks: 5)
What do you understand by leverage buy outs? Explain briefly
Leveraged Buyout – LBO
The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.
In an LBO, there is usually a ratio of 90% debt to 10% equity. Because of this high debt/equity ratio, the bonds usually are not investment grade and are referred to as junk bonds. Leveraged buyouts have had a notorious history, especially in the 1980s when several prominent buyouts led to the eventual bankruptcy of the acquired

companies. This was mainly due to the fact that the leverage ratio was nearly 100% and the interest payments were so large that the company's operating cash flows were unable to meet the obligation.
It can be considered ironic that a company's success (in the form of assets on the balance sheet) can be used against it as collateral by a hostile company that acquires it. For this reason, some regard LBOs as an especially ruthless, predatory tactic

Question No: 50 (Marks: 3)

Differentiate between Management Buyout and Management Buy-In.

Management Buyouts

Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company and the practical consequences that follow from that. In particular, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them. The seller is also unlikely to give any but the most basic warranties to the management, on the basis that the management knows more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company. In many cases, the company will already be a private company, but if it is public then the management will take it private.

Management Buy In (MBI):

Management Buy in (MBI) occurs when a manager or a management team from **outside** the company raises the necessary finance buys it and becomes the company's new management. A management buy-in team often competes with other purchasers in the search for a suitable business. Usually, a manager will lead the team with significant experience at managing director level. The difference to a management buy-out is in the position of the purchaser: in the case of a buy-out, they are already working for the company. In the case of a buy-in, however, the manager or management team is from another source.

Question No: 51 (Marks: 5)

Assume that a bookstore uses up cash at a steady rate of Rs.300,000 per year. The interest rate is 3% and each sale of securities costs Rs.20. Determine the optimal cash balance for the bookstore.

Optimal level of cash = √ (2FT / I)
= √ [(2 × 20 × 300,000) / 0.03]
= √ [12000000 / 0.03]
= √ 400000000
= Rs. 20000

Question No: 45 (Marks: 3)

How firms analyze their credit policies? Explain briefly.

Following factors to be considered:

1. *Revenue effects:* Granting credit period results in delayed revenue receipts. Offering discounts may or may not be utilized by the customers. Firm may charges higher prices for longer period and may increase revenue.
2. *Cost effect:* Whether firm sells on cash or credit it has to pay for the cost of sale. Payment to firm's creditor rests on the cash to be received from debtors.
3. *COST OF DEBT:* When a firm extends credit to customers, it must finance the resulting receivable. Cost of short term borrowing is an important factor in the decision to grant credit to customers.
4. *PROBABILITY OF DEFAULT:* Chances of default or bad debt are always there
5. *DISCOUNTS:* When firm offers discount to customers, there is a cost when some customers choose to pay early to seek discounts.

Question No: 46 (Marks: 5)

How Economic Order Quantity (EOQ) Model is helpful in the reduction of total inventory costs?

EOQ The amount of orders that minimizes total variable costs required to order and hold inventory. Re-order quantity is the quantity for which order is placed when the stock reached re-orders level. By fixing this quantity the purchaser has not to be to re-calculate the quantity to be purchased each time he orders for material.

EOQ only applies where the demand for a product is constant over the year and that each new order is delivered in full when the inventory reaches zero. There is a fixed cost charged for each order placed, regardless of the number of units ordered. There is also a holding or storage cost for each unit held in storage (sometimes expressed as a percentage of the purchase cost of the item). We want to determine the optimal number of units of the product to order so that we minimize the total cost associated with the purchase, delivery and storage of the product

The required parameters to the solution are the total demand for the year, the purchase cost for each item, the fixed cost to place the order and the storage cost for each item per year. Note that the number of times an order is placed will also affect the total cost; however, this number can be determined from the other parameters

Question No: 47 (Marks: 5)

Differentiate between Spot Rates and Forward Rates of currencies. Why forward rates are higher than spot rates?

Spot Rates: Foreign currencies can be traded on either spot or forward. Trading spot means that the settlement will be now – extended to two working days after the transaction is made. Buying or selling forward means that settlement will be made at an agreed future date. Therefore, there will be different rates for spot and forward for an identical pair of currencies. Forward contracts have settlement date up to one year with exception to major currencies where it can be two years.

Forward Rates of currencies: The exchange rate set today for a foreign currency transaction with payment or delivery at some future date.

Forward Rate: The agreed-upon exchange rate for a forward contract on a currency when a forward contract is made, the parties agree to buy/sell the underlying currency at a certain point in the future at a certain exchange rate. The rate is negotiated directly between the parties, unlike a futures contract, which trades on an exchange. Partly because there is little secondary market for forward contracts, determining the forward foreign exchange rate is a zero-sum game: one party will gain on the contract and one will lose, depending on the movements of the relevant currencies between the formation of the contract and its maturity

The current exchange rate at which a currency pair can be bought or sold the spot forex rate differs from the forward rate in that it prices the value of currencies compared to foreign currencies today, rather than at some time in the future. The spot rate in forex currency trading is the rate that most traders use when trading with an online retail forex broker.

Systemic and unsystematic risk (3 M)

SYSTEMATIC

- Economy-wide sources of Risk that effect all the stocks being traded in market.
- Systematic risk influences large number of assets and is also known as market risk.
- Systematic Risk is measured by Beta Coefficient or Beta.
- Beta measures the systematic risk inherent in an asset relative to the market as whole.

Systematic Risk:

• Systematic risks are unanticipated that effects all the assets to some degree. It is no diversifiable.

UNSYSTEMATIC

• It affects only specific assets or a firm. it is also known as Diversifiable or Unique or Asset- specific Risk.
It can be eliminated by Diversification therefore; a Portfolio with many assets has almost zero

Unsystematic Risk

• **Unsystematic Risk or Unique Risk:**

– It affects only specific assets or a firm. it is also known as Diversifiable or Unique or Asset- specific Risk. It can be eliminated by Diversification therefore; a Portfolio with many assets has almost zero Unsystematic Risk.

2) Capital ratio for investment (5)

A situation where a company has scarcity of funds to invest in potential opportunities and these opportunities are compared with one another in order to allocate resources most effectively and efficiently.

Question No: 49 (Marks: 3)

Explain the main features of a forward rate agreement.

Features of forward rate agreement

It is in between bank and client for fixing future interest rate on notional amount of loan. The loan is for an affirmed period starting on a particular time in future. The size of the notional loan or deposit is decided between the bank and the client. Forward rate agreement is cash settled. On settlement date buyer and seller must settle the agreement. The FRA rate for three months loan/deposit starting in a 6 months' time is normally expressed as 6v9 FRA. The buyer of a FRA agrees to pay fixed interest rate on notional loan. At the same buyer will receive interest on notional loan at standard rate of interest. On the other side, seller of FRA agrees to pay interest on the notional amount at benchmark rate and receives interest at a fixed rate.

Question No: 53 (Marks: 5)

Why exchange rates of two currencies fluctuate? Explain briefly

Following are some factors for fluctuation:

Relative interest rates: One factor that affects exchange rates is the size of the differential between the real interest rates available to investors in the respective countries. The real interest rate is simply the nominal interest rate available to an investor in a high quality short-term investment subtracted by the country's inflation rate.

Trade imbalances: The size of any trade deficit between two countries will also affect those countries' currency exchange rates. This is because they result in an imbalance of currency reserves among the trading partners.

Political stability: If a country's government becomes unstable due to political gridlock, votes of no confidence, revolution or civil war, confidence can quickly be lost. People become less willing to accept paper currency in exchange for their goods and services, primarily because they're unsure whether they'll be able to pass the paper along to the next person.

Government involvement: The relative value of a country's currency is of great importance to its government. The value of a country's currency affects the wealth of its citizens, the competitiveness of domestically produced goods, the relative cost of the country's labor, and the country's ability to compete. As a result, governments often try to influence the relative value of their country's currencies in a number of different ways, including altering their monetary and fiscal policies, and by directly intervening in the currency markets.

Investors: Perhaps the most powerful factor that can influence exchange rates over short time frames is the role that speculators play. Investors typically have tremendous amounts of capital that they can use to either buy or sell any currency. Consequently, their actions can cause the value of such currency to fluctuate, sometimes quite significantly.

Question No: 17

Calculate spread using Miller-Orr Model. Page 96

The Miller-Orr model computes the spread between the minimum and maximum cash balance limits as:

Spread = 3(0.75 x transaction cost x variance of daily cash flows / daily interest rate) ^(1/3)

3) Levered and un levered for firm (3)

Levered firm:
If Business has Debt & Equity (i.e. levered firm): for a levered firm range of ROE is high
LEVERED (Debt & Equity) Firm:
Higher Slope
ROE more sensitive to changes in EBIT
? UN levered firm:"
If Business is 100% Equity (or un-levered firm)
No Debt and No Interest. For UN levered firm this range is very short
Un-Levered (100% Equity): Lower ROE and Lower Risk.

4) Dividend policy and types.(5)
The policy a company uses to decide how much it will pay out to shareholders in dividends.
TYPES OF DIVIDEND

1. ***Cash*** (most common) are those paid out in form **of "real cash".** It is a form of investment interest/income and is taxable to the recipient in the year they are paid. It is the most common method of sharing corporate profits.
2. ***Stock or Scrip dividends*** (common) are those paid out in form of additional stock shares of the issuing corporation, or other corporation (e.g., its subsidiary corporation). They are usually issued in proportion to shares owned (e.g., for every 100 shares of stock owned, 5% stock dividend will yield 5 extra shares). This is very similar to a stock split in that it increases the total number of shares while lowering the price of each share and does not change the market capitalization
3. ***Property or dividends in specie*** are those paid out in form of assets from the issuing corporation, or other corporation (e.g., its subsidiary corporation). Property dividends are usually paid in the form of products or services provided by the corporation. When paying property dividends, the corporation will often use securities of other companies owned by the issuer.

Question No: 45 (Marks: 3)
Give at least three sources of synergies and explain each of them briefly.

1. **Staff reductions** - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments.
2. **Economies of scale** - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. When placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
3. **Acquiring new technology -** To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can maintain or develop a competitive edge.

Question No: 46 (Marks: 5)
How would you expect the firm's cash balance to respond to the following changes?

a) Interest rates increase.
b) The volatility of daily cash flow decreases
c) The transaction cost of buying or selling marketable securities goes up

Question No: 11 (Marks: 5)
Explain the process of re-organization of a firm in a financial distress.
Financial distress:
A situation in which available cash is insufficient to pay supplier, vendors, employees, banks and creditors is known as financial distress.
• Assumptions:

– Company is incurring losses.
– Needs immediate capital injections.
– Assets and liabilities are out of line with market value.

• Process:

– Revaluation of assets (Bring them to market value)
– Write of the debit balance on profit and loss account.
– To determine whether new capital / finances are needed?
• If yes, through which source (Shares / Loans)

Question No: 47 (Marks: 5)

The Inventory Manager of a firm has given the following data:
Consumption per Period = S = 4000 Units
Economic Order Quantity = EOQ = 80 Units
Lead Time = L = 1 Month
Stock out Acceptance Factor = F = 1.10
Requirement:
Determine the Economic Order Point for the firm.

EOP = SL + F √S x EOQ x L

Where

S= Consumption Per Period
L= Lead Time
F= Stock out Acceptance Factor
EOQ = Economic Order Quantity
S = 4000 Units
EOQ = 80 Units
L = 1 Month
F= 1.10 (This Represents the Stock out level of say, 10%)

EOP = SL + F √S x EOQ x L
= 4000 x 1 + 1.10 √4000 x80 x 1
= ***4622.25 Units***

Question No: 48 (Marks: 5)

How a firm can create a money market hedge against transaction exposure, when the firm has to make a payment at some future date?

Money Market Hedge – future FCY payment scenario

A similar approach will be taken to create the hedge when a firm is expecting to pay in FCY in future. In this scenario, a hedge can be created by exchanging local currency for FCY now using spot rates and putting the currency on deposit until the future payment is to be made. The amount borrowed and the interest earned on the deposit should be equal to the FCY. If it is not the case then it will not be a clean hedge. The cash flows are fixed because the cost in local currency is the cost of buying FCY on spot rates that was put under a deposit.

Mechanism:

- **Step 1**: determine the FCY (assume US $) amount to be put to a deposit that will grow exactly to equalize the future payment in dollars. You need to calculate this using the available spot rates and interest rate on dollar deposit.
- **Step 2**: in order to deposit dollars in interest bearing account, the company will buy dollars at spot rates.
- **Step 3**: the company will borrow local currency for the period of hedge. These steps will ensure that the hedge created a definite cash flow regardless of exchange rate or interest rate fluctuations. The exchange rate has been fixed.

Question No: 49 (Marks: 10)

Describe in detail the major steps in short term financial planning process of a firm.

The Financial Planning Process consists of the Following five Steps

1. **Establishing and defining the client-planner relationship** The financial planner should clearly explain or document the services to be provided to you and define both his and your responsibilities. The planner should explain fully how he will be paid and by whom. You and the planner should agree on how long the professional relationship should last and on how decisions will be made.

2. **Gathering client data, including goals** The financial planner should ask for information about your financial situation. You and the planner should mutually define your personal and financial goals, understand your time frame for results and discuss, if relevant, how you feel about risk. The financial planner should gather all the necessary documents before giving you the advice you need.
3. **Analyzing and evaluating your financial status** The financial planner should analyze your information to assess your current situation and determine what you must do to meet your goals. Depending on what services you have asked for, this could include analyzing your assets, liabilities and cash flow, current insurance coverage, investments or tax strategies.
4. **Developing and presenting financial planning recommendations and/or alternatives** The financial planner should offer financial planning recommendations that address your goals, based on the information you provide. The planner should go over the recommendations with you to help you understand them so that you can make informed decisions. The planner should also listen to your concerns and revise the recommendations as appropriate.
5. **Implementing the financial planning recommendations** You and the planner should agree on how the recommendations will be carried out. The planner may carry out the recommendations or serve as your "coach," coordinating the whole process with you and other professionals such as attorneys or stockbrokers.

Q 3.Compare and contrast the Stable Dividend per share policy and Constant dividend payout policy. Marks 5

CONSTANT DIVIDEND PAYOUT

- A fixed %age is paid out as dividend.
- Under this policy the dividend amount will vary because the net income is not constant.

STABLE DIVIDEND PER SHARE:

- Per share fixed amount of dividend paid every year.
- Look favorably by investors and implies low risk firm.
- Investors can easily forecast and predict their earnings.
- Aid in financial planning

AGGRESSIVE AND DEFENSIVE STOCKS:

• Aggressive Stocks have high betas, greater than 1, meaning that their return is more than one-to-one to changes in return of overall market.

• Defensive stocks are less volatile to change in market return and have beta of less than one

How Forward Rates are Determined in foreign Currency Market? Explain Briefly. (5 Marks)

Under this method, hedging refers to making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Using this method, we can fix the exchange rate now for a future transaction of the needed currency.

Because spot rates are changing every day and fixing the exchange rate for future date 'now' reduces the risk to significant extent.

A forward contract is binding upon both the parties – currency dealer and a company/client. This means that both parties must honor their commitment to sell or buy the foreign currency on the specified date and amount. By hedging against the risk of an adverse exchange rate movement with a forward contract, the company also closes an opportunity to benefit from a favorable change in the spot rate.

How a Multinational Firm could reduce Political Risk? (5 Marks)

1) Confiscation risk

The risk of loss of control, business may be taken over by the local govt. or intervention and interference by the local authorities. This risk can be reduced by insurance policies.

A JV would be preferable in less or developing country. A subsidiary would be preferable in stabled and developed countries. Even then, this risk is present and can be reduced by:

- High gearing

- High local loans/finances
- Share in equity from local resources

2) Commercial risk

- There may be discriminative laws for foreign companies – wages level or lower prices for products, repatriation of profits and more emphasis to use local resources.

3) Financial risk

- Restricted access to local resources – loans etc
- Terms of maximum foreign equity
- Restrictions on repatriation of capital and dividend
- Exchange and currency risk
- Measurement & management of political risk
- Comparative techniques like rating mapping
- Analytical techniques – special reports, expert opinion

Differentiate Between the Following Variable of a Credit Policy: (5 Marks)

1) Credit Period:

The credit period is the length of time that is allowed to debtors to pay off their bills. It will vary business to business and firm to firm. Normally this period is between 30 to 60 days, however, 90 days credit is not very un-common. Credit period count runs from the invoice date but can be the point of delivery of goods. The credit period is the length of time that is allowed to debtors to pay off their bills. It will vary business to business and firm to firm. Normally this period is between 30 to 60 days, however, 90 days credit is not very un-common. Credit period count runs from the invoice date but can be the point of delivery of goods

2) Credit Standard:

Credit standard are set to regulate the collection from debtors. The company must have clear credit standards by defining the minimum quality of credit worthiness of debtors that is acceptable to the firm.

3) Collection Policy:

This is the last item in designing credit policy. This phase encompasses:

• The company must keep track of average collection period (ACP). The monitoring of ACP will also consider seasonal effects.

• Aging schedule: a compilation of accounts receivable by the age of each account.

• Collection effort for overdue or delinquent accounts.

4) Discounts

In order to induce the debtors to settle their invoices at the earliest the company offers a discount or reduction in the invoice amount. That discount is predominantly based on receiving the payment within a very short period of time compared with normal credit period. For example, the normal terms representing the period and discount are described as “3/10, net 45”.

This means that the credit period is 10 days. The credit period is the length of time that is allowed to debtors to pay off their bills. It will vary business to business and firm to firm. Normally this period is between 30 to 60 days, however, 90 days credit is not very un-common. Credit period count runs from the invoice date but can be the point of delivery of goods.

Type of merger and how companies reduce risk in merger (3 marks)

- *Horizontal merger -* Two companies that are in direct competition and share the same product lines and markets.
- *Vertical merger -* A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.
- *Market-extension merger -* Two companies that sell the same products in different markets.
- *Product-extension merger* **-** Two companies selling different but related products in the same market.
- *Conglomeration -* Two companies that have no common business areas.

Method of valuation of share in merger & acquisition (5 marks)
When the consideration of merger transaction has been decided to be settled in shares, then comes the stage to determine the value of share. There are some reasons why we need to value the shares.

- To set up the terms of takeovers
- To value the company for stock exchange listing
- For tax purposes
- To value shares – for establishing value of share of retiring directors

The different values are returned by different methods of valuation and sometimes these are wide apart. In this scenario, the final value will be a matter of negotiations between the both parties.

What is mean by long position and short position of foreign currency traders in the currency market? 5
When a trader buys future, this represents taking a long position in futures. Such a trader having a long position can close his position at any time before the settlement date by selling the same number of contracts. On the other side, when a trader is selling futures then it represent his or her short position. It is possible to sell future even you don't have them. A trader who is in short position can close her position by buying the same number of future before the final settlement date.

What are the costs and benefits of holding inventories? 3 Marks
Benefits.

_ Inventory will be available to meet sales.
_ There will be no stock outs and no danger of rejection of order placed by customers.

Costs

_ Carrying costs, re-order costs etc will be more if less inventory is maintained.
_ if a huge amount of inventory I to maintained then a lot of capital must be invested in inventories. So there will be no capital for other opportunities.

How it is decided to exercise an Option Contract or allowed it to lapse? Briefly explain. 3
Everyone looks for his/her profit. An option gives the holder right, not an obligation, to buy/sell assets on some future date. So if the strike price of an option is favorable i.e. less than market price then it will be termed as "In the Money" and will option holder will exercise it.
On the other hand if the strike price is not favorable i.e. higher than the market price it will be termed as "Out of Money" and option holder will not exercise it and will allow it to lapse.

What is the payoff to buyers and sellers of call and put options? 5
_ Call option gives its holder the right, not the obligation to buy underlying item at the specific price.
_ Put option gives its holder a right, not the obligation to sell underlying item at the specific price.
_ The strike price of an option may be lower, higher or equal to to the market price of underlying asset.
So the seller must have to sell and buyer must have to buy if other party decides to exercise the option no matter what it costs to them. So they can bear a loss.
It's a kind of agreement in which both the parties cannot be satisfied and one have to bear the loss.

How much should you pay for a bond with Rs.1,000 face value, a 14 percent coupon rate, and five years to maturity if your appropriate discount rate is 10 percent and interest is paid semiannually? 5

Face Value = 1000
Coupon Rate = 14%
Years to Maturity = 5 years
ROR = 10%

Present Value = 140/(1+10%/2)^2 + 140/(1+10%/2)^4 + 140/(1+10%/2)^6 + 140/(1+10%/2)^8 + 140/(1+10%/2)^10 + 1000/(1+10%/2)^10

= 126.98 + 115.178 + 104.47 + 94.76 + 85.95 + 613.91 ***= 1141.25***

Highlight the main feature of currency future 3

Currency Futures:

A currency future is a standard contract between buyer and seller in which the buyer has a binding obligation to buy a fixed amount, at a fixed price and on a fixed date of some underlying security.

Fixed amount = contract size
Fixed date = delivery date
Fixed price = future price

Futures are forward contracts traded on future and option exchanges. There are several such exchanges around the world and although some trade in similar forward contracts, as a general rule each exchange specializes in its own future contracts. This means that if a company wants of trade in future contracts it has to go to exchange where those contracts are traded.

Different between a currency option and an equity option 3

Currency option is a contract like equity options that we have covered in previous section. This is a contract, which confers right to the buyer to buy or sell (but not obligation) a fixed amount of underlying currency at a fixed price (strike price) on a fixed date (expiry).
Amount of underlying currency is governed by the contract size as determined in each currency. A buyer of a call option has a right but not the obligation to buy the underlying currency. A buyer of a put option has a right but not the obligation to sell the underlying currency. Premium is charged by option writer from option holder.

How firm analysis their credit policies 5

When a firm allows credit to its customers there are some effects that should be considered.
First, allowing credit to customers means that the revenues to the firm will be delayed. A firm may charge higher prices to the customers for allowing them on credit and this will result in increased sales. Total revenues may increase but still the company will receive it late.
Secondly, if the company allows credit to customers and then offers cash discounts for early payment from debtors it will incur cost of discount. In other words, it is reducing its profits.
After allowing credit to parties the firm must arrange some loans to finance its short term operations. Such finances do carry a handsome interest rate and this need to be considered.
Increasing sales by allowing generous credit to customers also increased the probability of default and thus may incur bad debts.

How fixed exchange rate system is different from a floating exchange rate system. Briefly explain 3

Fixed

There are two ways the price of a currency can be determined against another. A fixed, or pegged, rate is a rate the government (central bank) sets and maintains as the official exchange rate. A set price will be determined against a major world currency (usually the U.S. dollar, but also other major currencies such as the euro, the yen, or a basket of currencies). In order to maintain the local exchange rate, the central bank buys and sells its own currency on the foreign exchange market in return for the currency to which it is pegged.

Floating

Unlike the fixed rate, a floating exchange rate is determined by the private market through supply and demand. A floating rate is often termed "self-correcting", as any differences in supply and demand will automatically be corrected in the market. Take a look at this simplified model: if demand for a currency is low, its value will decrease, thus making imported goods more expensive and thus stimulating demand for local goods and services. This in turn will generate more jobs, and hence an auto-correction would occur in the market. A floating exchange rate is constantly changing.

Give at least three reasons of Management Buy Out. 3

Reasons for Buyouts:

The existing parent company of the victim firm may wish to dispose of it. The parent company may be caught up in financial distress and is in acute need of cash and liquidity. The subsidiary on the other hand, is not strategically fit with parent's overall business strategy.

In case of loss making, selling the unit to its management may be the better option than to dispose or putting into liquidation, which has it own costs.

The purpose of such a buyout from the managers' point of view may be to save their jobs, either if the business has been scheduled for closure or if an outside purchaser would bring in its own management team. They may also want to maximize the financial benefits they receive from the success they bring to the company by taking the profits for themselves.

If a firm wants to use the other firm's assets by acquiring it, how it should be valued, by share valuation or by asset based valuation? Explain

There are several variants on asset based valuation models. The first is liquidation value, which is obtained by aggregating the estimated sale proceeds of the assets owned by a firm. The second is replacement cost, where you evaluate what it would cost you to replace all of the assets that a firm has today.

While analysts may use asset-based valuation approaches to estimate value, we do not consider them alternatives to discounted cash flow, relative or option pricing models since both replacement and liquidation values have to be obtained using one or more of these approaches. Ultimately, all valuation models attempt to value assets – the differences arise in how we identify the assets and how we attach value to each asset. In liquidation valuation, we look only at assets in place and estimate their value based upon what similar assets are priced at in the market. In traditional discounted cash flow valuation, we consider all assets including expected growth potential to arrive at value.

The two approaches may, in fact, yield the same values if you have a firm that has no growth assets and the market assessments of value reflect expected cash flows.

Asset based methods are generally considered suitable when shareholdings > 50% are being valued. Such shareholdings give the holder the right to control the acquisition and disposal of the underlying assets.

Therefore, if there are assets not needed for generation of income, the controlling shareholders may cause these to be realized to generate cash.

Write a brief note on factoring (5

Factoring refers to an arrangement where debt collections and some related functions are performed by someone else than the firm itself. The person or entity who performs such functions charges a fee that may be a specific percentage of total debtors. Factor normally advances a proportion of the amount to be collected and the rest when he actually recovers the amount from firm's debtors after deducting his commission or fee agreed in advance. The other factor functions may be like:

Main function of a factor is to collect the accounts receivables on behalf of seller but may also involve in invoicing and sales accounting.

Exact term of factoring will depend on mutual agreement.

Factor also takes over the risk of loss in case of bad debt.

Factor also insures client against such losses. This type of factoring is known as non-recourse. In case of action against defaulters, factor initiate action.

Question No: 43 (Marks: 3)

How the following shall affect the size of the firm s optimal investment in current assets?

a. The interest rate rises from 6% to 8%.

b. A just in time inventory system is introduced that reduces the risk of inventory shortages.

c. Customers pressure the firm for a more lenient credit sales policy.

<u>Question No: 45 (Marks: 3)</u>

An American exporter sold goods worth $1,000,000 to a Pakistani importer. What type of currency risk would American exporter face, if Pakistani importer promises to pay the amount after three months? Explain.

<u>Question No: 52 (Marks: 5)</u>

Firm A wants to acquire a private limited company operating in the same industry. What procedure would be followed by the Firm A to acquire the target company?

The Great Genius Final Term Paper (Subjective Questions)

Question # 57

How Mergers & Acquisitions Improved market reach and industry visibility.

Answer:

Improved market reach and industry visibility - Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

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Question # 58

Reward Ratio + risk premium

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Question # 59

Fixed exchange rate

Handout Page 146+147

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Question # 60

Equity Beta using Pure Play method

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Question # 61

Short position and long position of exchange trader

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Question # 62

What are the reasons of valuation of shares under ACQUISITIONS

Answer:

Valuation of shares:

when the consideration of merger transaction has been decided to be settled in shares, then comes the stage to determine the value of share. There are some reason why we need to value the shares.

- to set up the terms of takeovers
- to value the company for stock exchange listing
- for tax purposes
- to value shares – for establishing value of share of retirng directors

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Question # 63

Types of foreign transactions exposure

Answer:

Currency Risks
We can classify foreign risk exposure into three broad categories:

- Transaction exposure
- Translation exposure
- Economic exposure

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Question# 64

A company is considering taking the loan of Rs.5 million on which it has to pay semiannual interest at KIBOR plus 1.5%. Company intends to enter into an option against rise in interest rates by buying a CAP at a strike rate of 8%.
There will be two expiry dates within the agreement:

Expiry Six month KIBOR at expiry Period
30 - June Year 1 9% July - Dec. Year 1
31 - Dec. Year 1 6% Jan - June Year 2

Required:
1. At which expiry date option will be exercised and why?
2. Calculate cash payment if the option is exercised.