Name : ....
Roll No. : ....
Invigilator's Signature : ....

CS/MMA/SEM-3/MMAFNE-302/2009-10

2009

CAPITAL FORMATION

Time Allotted : 3 Hours Full Marks : 70

The figures in the margin indicate full marks.

Candidates are required to give their answers in their own words as far as practicable.

GROUP – A
(Multiple Choice Type Questions)

1. Choose the correct alternatives for the following : $10 \times 1 = 10$

 i) A single, overall cost of capital is often used to evaluate projects because

  a) it avoids the problem of computing the required rate of return for each investment proposal

  b) it is the only way to measure a firm's required return

  c) it acknowledges that most new investment projects have about the same degree of risk

  d) it acknowledges that most new investment projects offer about the same expected return.

ii) To compute the required rate of return for equity in a company using the CAPM, it is necessary to know all of the following *except*

a) the risk-free rate

b) the beta for the firm

c) the earnings in the next time period

d) the market returns expected for the time period.

iii) In calculating the costs of the individual components of a firm's financing, the corporate tax rate is important to which of the following component cost formulas ?

a) equity capital

b) debt capital

c) preferred capital

d) all of these.

iv) The equity capital of a company must provide a higher expected return than the debt of the same company because

a) there is less demand for shares than for bonds

b) there is a greater demand for shares than bonds

c) there is systematic risk for shares

d) there is a market premium for bonds.

v) Market values are often used in computing the weighted average cost of capital because

a) this is the simplest way to do the calculation

b) this is consistent with maximizing shareholder value

c) this is required by the SEBI

d) this is how it is done in all countries.

vi) Which of the following is an argument for the relevance of dividends ?

a) informational content

b) reduction of uncertainty

c) some investors' preference for current income

d) all of these.

vii) All of the following are *True* of stock splits *except*

a) market price of the stock is reduced after the split

b) the number of shares outstanding are increased

c) retained earnings are changed

d) proportional ownership is unchanged.

viii) The Modigliani-Miller dividend model says that

a) dividends are relevant

b) dividends are only partially relevant

c) dividends are irrelevant

d) dividends should not be paid at all.

ix) An offer by a firm to repurchase some of its own shares is known as

a) a DRIP
b) a buy back
c) a self-tender offer
d) a share split.

x) The dividend-payout ratio is equal to

a) the dividend yield plus capital gains yield
b) the dividend per share divided by par value per share
c) dividend per share divided by current price per share
d) the dividend per share divided by earnings per share.

GROUP – B
(Short Answer Type Questions)

Answer any *three* of the following. $3 \times 5 = 15$

2. A company decided to issue Rs. 20 lakhs of Rs. 1000, 14%, 7 year debentures. The debentures will be sold at a discount of 3%, Underwriting commission will be 5%. If the tax rate is 35% what will be the cost of the debt ? What would be the cost, if the debentures were to be redeemed at a premium of 15% ?

3. A company is considering issuing debt of Rs. 100 lakhs by one of two alternative methods, *i.e.* 14% term loan or 13% non-convertible debentures. The term loan has no incidental cost. The debentures would have to be issued at a discount of 6% and would involve Rs. 2 lakhs as cost of issue. Assume a tax rate of 35%. Which is the better option ?

4. A firm has 80,000 ordinary shares outstanding. The current market price is Rs. 250, the earnings per share are Rs. 36 and the D/P ratio is 60%. What is the cost of equity if the growth rate is 6% ?

5. What is a stock split. How is it advantageous to a company ?

6. A company has an investment of Rs. 3 crores divided into 30 lakhs ordinary shares. The profitability rate for the firm is 20% and the capitalisation rate is 12%. What is the optimum dividend payout for the firm if Walter's model is used ?

7. What are the assumptions that underline Gordon's model of dividend effect ?

GROUP – C
(Long Answer Type Questions)

Answer any *three* of the following. 3 × 15 = 45

8. Explain the nature of the factors which influence the dividend policy of a firm.

9. What are bonus issues and share splits ? What are the effects of bonus issue and share split on the earnings per share and the market price of the share ?

10. How is corporate dividend behaviour determined ? Explain Lintner's model in this regard.

11. What do you mean by stability of dividends ? What is the significance of stability of dividends ?

12. The following information is available for *Y* Ltd.

    Earnings per share Rs. 60

    Rate of return on investments 20%

    Required rate of return of shareholders 16%

    What will be the price of the share as per Gordon's model if the payout ratio is

    a) 25%

    b) 50%

    c) 75%.

13. The earnings per share of a company is Rs. 80 and the rate for capitalization applicable is 12%. The company has an option of 50% or 75% dividend payout ratio. Compute the market price of its share as per Walter's model if it can earn a return of (i) 15%, (ii) 18% on its retained earnings.

14. A company currently has 1,00,000 outstanding shares selling at Rs. 100 each. The firm is considering to declare a dividend of Rs. 5 per share at the end of the year. The firm's opportunity cost of capital is 10%. What will be the price of the share at the end of the year if (i) dividend is declared, (ii) if dividend is not declared ?

Assuming that the firm pays the divided, has net profits of Rs. 10 lakhs and makes new investments of Rs. 20,00,000 during the period, how many new shares must be issued ? Use MM model.