Biyani's Think Tank

Concept based notes

Finance of Strategic Decisions

MBA Part-III

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Biyani's
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Preface

I am glad to present this book, especially designed to serve the needs of the students. The book has been written keeping in mind the general weakness in understanding the fundamental concepts of the topics. The book is self-explanatory and adopts the “Teach Yourself” style. It is based on question-answer pattern. The language of book is quite easy and understandable based on scientific approach.

Any further improvement in the contents of the book by making corrections, omission and inclusion is keen to be achieved based on suggestions from the readers for which the author shall be obliged.

I acknowledge special thanks to Mr. Rajeev Biyani, *Chairman* & Dr. Sanjay Biyani, *Director* (*Acad.*) Biyani Group of Colleges, who are the backbones and main concept provider and also have been constant source of motivation throughout this Endeavour. They played an active role in coordinating the various stages of this Endeavour and spearheaded the publishing work.

I look forward to receiving valuable suggestions from professors of various educational institutions, other faculty members and students for improvement of the quality of the book. The reader may feel free to send in their comments and suggestions to the under mentioned address.

Author

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Syllabus

Section A

An Overview of the Financial System- Saving and Investment, Money, Inflation & Interest, Banking and Non Banking Financial Intermediaries.

Financial institutions and economic development: nature and role of financial system: financial system and financial markets, efficiency, stability, technology, government intervention in the financial system.

Financial Markets and Instruments- Money market and Capital Markets, Financial Instruments: REPO, TBs, Equities, Bonds, Derivatives etc. Characteristics of Financial Instruments: Liquidity, Maturity, Safety & Yield.

Concept of strategic decisions-changing global economic environment. Valuation of strategic options- merger and acquisition. Pricing & Planning, Strategy, Diversification & Merger-The Indian Cases. Strategic decisions regarding financial services-

Valuation of exchange rate mechanism, strategic decisions regarding securitization factoring and forfeiting, value creation and value based financial strategy.

Analysis of enterprise – concept of valuation EVA, MVA, enterprise value. Analysis of corporate financial models.

Section B
Case and Problems

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Chapter- 1

An Overview of the Financial System

Q.1 Explain in brief concept of investment and attributes of investments. What are the key points to be kept in mind by a investor in making investments and what are the investment avenues available today for a investor?

Ans. Investment is the employment of funds with the aim of getting returns on it. Funds are saved from current consumption with the hope to get benefits from these funds in future. There are two concepts of investment.

Economic concept:- in economic term, investment means increase in building, equipments, inventory etc i.e. capital stock of society. It implies formation of new and productive capital.

Financial concept:- investment means exchange of financial claims such as shares, bonds, real estate etc. Financial investment means investment in shares, debentures, fixed deposits, NSC, LIC polices, provident funds etc to derive future income in the form of interest, dividend, premium rent, pension benefit leading to appreciation in the value of principal amount invested.

Investment attributes:- Every investor has certain specific objectives to achieve through his short term and long term investments. Such objectives may be:

- **Monetary/ Financial** :- These include
  - Safety and security of funds invested
  - Profitability (through interest, dividend & capital appreciation) &
  - Liquidity (convertibility in to cash as & when required)

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Besides above, investor would not like to take undue risk about his principal amount even interest rate offered is attractive.

- **Personal objective** – which are given due consideration by investor like provision for old age & sickness, provision for house construction, education and marriage of children, provision for dependents like wife and physically handicapped members of family

Investment avenue selected should be suitable for achieving both the objectives i.e. financial as well as personal. Two important factors considered are

- Period of investment –which relate to liquidity
- Risk in investment – relate to non-payment of principal or interest there on

Factors effecting selection of suitable avenue for investment

- Investment objective
- Period of investment
- Risk in investment
- Market standing of borrowing agency
- Future marketability
- Loan facility
- Returns on investments
- Tax benefits

Investment Avenues

- Investments in shares, debentures & bonds of different companies, corporations, and public sector organizations
- Postal saving schemes
- PF, PPF and other tax saving schemes such as NSC, LIC schemes, infrastmeture bonds etc.
- Deposits in banks, public sector organizations, public deposits in companies
- LIC policies

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- Gold, silver, precious metals and antiques
- Investments in real estates
- Investments in gild edged securities (securities of Govt. and semi-Govt. organizations)

Various Tax saving schemes

- Public provident fund (PPF)
- Tax saving schemes of post office like NSC,NSS etc
- Investment in tax saving infrastructural bonds issued by IDBI, ICICI etc.
- Life Insurance schemes with tax benefit
- Investment in mutual funds with tax benefit (e.g. SBI Magnum tax gain mutual fund)
- Investment in residential house where tax benefit is there on interest and principal amount
- Investment in various pension plans of LIC and other insurance companies where tax benefit is available.
- Mediclaim and health insurance

Q.2 Explain the concept of money, its types and functions of money.

Ans. Money is something that is widely used and accepted in transactions involving transfer of Goods and services from one person to another. However, it is difficult to define it. Different authors has tried to define money in their own way. Some of the definitions are given below:

H. Withers :- "The stuff with which we buy and sell things"

Crowither:- "Anything that is generally accepted as a means of exchange (i.e. means of settling debts) and that at the same time acts as a measure and as a store of value"

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J.M. Keynes :- "Money is thing by delivery of which debt contracts and price contracts are discharged and in the shape of which a store of general purchasing power is held"

A common thing which is there in above definitions is emphasis on functions of money.

Functions of Money :- Money is a matter of four key functions i.e.a medium, a measure a standard and a store. These four are also considered as primary functions of money. All these four are explained below in brief:

(i) A medium of exchange: Money's most important function is as a medium of exchange. Without money, all transactions would have to be conducted by barter which involves exchange of goods or service for another. This barter system has its own inherent problems of equal value and desire of same goods between two exchangers.

(ii) Measure of value : With the help of money, we are able to express the value of every commodity by its price. Money through this function has removed the difficulty of barter system. Money has provided a common measure of value.

(iii) Store of value : Another key function of money is in the form of store of value. It is more liquid than all other stores of value because as a medium of exchange, it is readily accepted everywhere. Money is also easily transported store of value that is available in convenient denominations.

(iv) Standard for deferred payment : Money is used as a standard for deferred payments i.e. payments that have to be made at a later stage. It is money that makes it possible, because it can be used as a standard for such deferred payments. In todays world, it is very important as most of the transactions are made on credit basis.

Other functions:

(v) Transfer of value – from one place to another as buyer and seller may be from different places.

(vi) Money as a liquid asset- Money is widely acceptable and hence people would like to hold it to meet contingencies or to hold purchasing power.

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(vii) Unit of account – helps in maintaining accounts of amount receivable, payable and also helps in preparation of final accounts to know results of business in term of profit or loss.

(viii) Basis of credit – It serves as a basis of credit. The great superstructure of credit is built on money.

Kinds/ Types of money

(1) <u>On the basis of accountability</u>

(a) **Legal tender Money** – When Govt. grants legal status to certain kind of money i.e. every individual is bound to accept. It may be:

<u>Limited Tender Money</u> – Which is accepted to a limited extent e.g. coins of 5,10,20,25 paisa are accepted only up to Rs. 25 and beyond a person can refuse to accept.

<u>Unlimited tender Money</u> – Which is legally acceplable without any limit e.g. coins of 50 paisa, one rupee, two rupee and currency of all denominations. It a person refuses to accept, legal action can be initialed against him

<u>(2) Optional Money</u> – It is non legal tender money. It is for the person to accept or not in the discharge of debt. Credit instruments like cheque, bank draft, bill of exchange etc are optional money. Generally people accept them but they cant be forced to accept it.

<u>(3) On the basis of material used</u>

(i) Metallic Money – Money made of metal e.g. coins are made of metal. Metallic money is further divided in to two i.e.

(a) Standard Money – It is known as full bodied money and its face value is its intrinsic value. It is generally made of gold or silver.

(b)Token Money – Opposite to standard money, its is limited legal tender. Our one rupee is token legal tender money.

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(ii) Paper money- Made of paper and is classified in 4 sub heads:

(a) Representative paper monley – Paper money which is fully backed by gold or silver and redeemable at the option of holder in gold or silver.

(b) Convertible paper money – Hundred percent backing of gold or silver is not desired but convertible at the option of holder.

(c) Inconvertible paper Money- Kind of paper money which can not be converted in to gold or silver by holder e.g. Indian one rupee note.

(d) Fiat money – In convertible paper money which is generally issued without any backing of gold or silver under extra ordinary circumstances.

(4) Money and Near Money – The liquidity basis

(a) Liquid form of money – always exchangeable for full value e.g. coins and currency notes

(b) Near money – Not liquid like currency notes or coins but easily convertible in liquidity like NSC, TB's, FD Receipt, shares and debentures, bill of exchange etc.

(5) Credit Money and bank Money – Most popular form of money. It is also known as bank money e.g. cheques issued against deposits in bank. By issuing cheques goods and services can be purchased as banks promise to make payment of cheques if a customer is having balance in his account with bank.

Q.3 Explain the concept of interest and inflation. What are the causes of inflation and how inflation can be controlled ?

Ans. **Interest**- is fee paid on borrowed money/ capital. It can be thought of rent of money. The fee is compensation to lender for forgoing other useful investments that could have been made with the loaned money. The amount lent or the value of asset lent is called the principal. This principal value is held by the borrower on credit. Interest is there fore price of credit. The percentage of principal that is paid as fee over certain period of time is called interest rate.

Type of interest

(i) **Simple interest** – Calculated on principal (Unpaid amount) at specified rate e.g. interest @10% on Rs. 1000 comes to Rs. 100 for full year.

(ii) **Compound interest** – Calculated on principal but interest earned is added in principal. Compounding is done generally quarterly e.g. interest @10%on Rs. 1000/- for first quarter would be Rs. 25. for next quarter, interest @10% would be calculatd on Rs. 1025 which would be slightly more than Rs. 25. This system goes on in compound interest and in one year, the amount earned @10% on principal amount of Rs. 1000/- would be more than Rs. 100/-

(iii) **Fixed and floating interest rate** – commercial loans generally use compound interest but interest is not same throughout the life of loan. Loan for which interest rate does not change are referred to fixed rate loans. Loans for which interest rate changes are known as floating rate or variable rate or adjustable rate loans.

Inflation: Inflation generally refers to rise in prices of specific goods or services. Inflation is usually measured as percentage rate of change of a price index. Two widely known indices for which inflation rates are reported in many countries as a consumer price index (CPI) which measures consumer prices and GDP deflator which measures price variations associated with domestic production of goods and services.

Various types of price indices used for measuring inflation are :

- Consumer price indices (CPI)
- Cost of living indices (COLI)
- Producers price indices (PPI)
- Commodity price indices (Prices of selected commodities)
- GDP Deflator- i.e. price of all the goods and services included in gross domestic product (GDP)
- Capital Goods price indices

Causes of inflation- Generally inflation is caused by two reasons i.e.

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1. Shortage/ scarcity of goods or service which may arise due to:
   - Less production of goods & services
   - With holding stock and creating artificial scarcity in market
   - Exceptional situation like war, flood, emergency etc.
2. Increase in money supply in market which may be due to:
   - Increase in wages/ salaries
   - Releasing incentives like booms ex-gratia on the eve of festivals
   - Releasing more money by central bank in exceptional situation/ circumstances.

Controlling Inflation – Central bank such as Reserve Bank of India takes measures to control inflation through setting interest rates and various other monitary measures like increasing cash reserve ratio, increasing statutory liquid ratio, increasing bank rate, repo rate, increasing margin on some loans, rationing of credit. Besides RBI, Govt takes various measures through which production & supply of Goods and services could improve and control on wage/ salaries. However, Govt has to be cautions that serious steps taken should not lead to recession.

Q.4 What do you understand by banking and non banking financial intermediaries? Explain in brief.

Ans. The term financial intermediary includes all kinds of organization which intermediate and facilitate transactions of both individuals and corporate customers. In fact it includes all kinds of financial institutions and investing institutions which facilitate financial transactions in financial market. They may be classified in to:

- Organized sector
- unorganized sector
- Capital market intermediaries
- Money market intermediaries
- Banking intermediaries

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- Non- banking intermediaries

Here, we are concerned with last two i.e. banking and non-banking financial intermediaries.

Banking intermediaries:- are those which work as intermediary and perform various banking functions and provide various banking services i.e. fee based services and fund based services. The RBI as leader controls these banking intermediaries. The banking intermediaries can be classified mainly in to two. i.e.

1. Commercial Banks &
2. Cooperative Banks

Commercial Banks can be further subdivided in to three i.e.

(i) Public sector banks
(ii) Private sector banks
(iii) Foreign banks

Public sector banks are those where more than 50% ownership is of Govt. Three types of banks are in this category i.e.

(i) Nationalized Banks
(ii) State Bank of India and its subsidiary banks
(iii) Regional Rural Banks

while 14 banks were nationalized in 1969, another 6 were nationalized in 1980. The state bank of India was nationalized in 1955 and six more subsidiaries were formed subsequently. The Regional Rural Banks were created through RRB act 1974 where ownership belongs to central Govt, state Govt and sponsored bank. This whole group of these 3 types of banks i.e. nationalized banks, SBI group and RRB,s are known as public sector banks as more than 50% ownership is of Govt in these banks.

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The other important component of commercial banks are private sectors banks and foreign banks. We have big private sector banks like ICICI Bank, HDFC Bank, Kotak Mahindra Bank, Induslnd Bank etc. Similarly, Major foreign banks in India are ABN –AMRO Bank, Citi Bank, HSBC Bank, American Express Bank etc.

Cooperative Banks- These banks are classified in two parts i.e. banks engaged is disbursement of agricultural credit and those engaged in non- agricultural credit business.

(i) **Agri-credit** – In this category, we have state coop. Banks at state level and District central coop. Banks at district level. At primary level, there are primary agricultural credit coops which are generally. known as PACS which are directly dealing with members. These PACS borrow loan from District Banks. The first two come in the category of banks. This structure is there for short & medium term agricultural credit. For long term agri-credit we have state coop. Agr. & Rural Dev. Bank at state level and Primary Coop. Agr. &Rural Dev. Banks at taluka/ primary level. These two do not fall in the category of banks.

(ii) **Non- agricultural credit** – There are Urban cooperative Banks and Inustrial cooperative Banks. Urban Coop. bank may be scheduled or unscheduled and a few are multi state banks. These all are falling in the category of banks.

Besides commercial banks and cooperative banks, we also have post office saving Bank, which are also working as intermediaries and callect various types of deposits from public.

They are fully owned by central Govt and money collected is used for developmental activities.

Non- Banking intermediaries – Are those which are not working like banks but working as intermediary institutions and collect savings from public. These institutions are as follows.

1. **Life Insurance Corporation of India** – Which collects insurance premium for life insurance and then invest this money in various schemes

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2. **General Insurance companies** – Which deal in non-life insurance and collects savings for various non-life insurance schemes.
3. **Unit trust of India**:- Which collect savings in the form of selling units to public
4. **Development Banks** – Which takes responsibility of development a particular sector of economy

   e.g.

   - NABARD- Which acts as a development bank for agricultural and rural development
   - National Housing Bank – Which acts as a development bank for developing housing sector in the country by providing loan for housing projects.
   - Dev. Banks for Industries – There are many institutions for development of industries at national and state level. The institution at national level are known as all India Dev. Finance Institutions like IFCI, IDBI, ICICI, IRBI etc.
5. Non banking finance companies- Which work as financing companies and are controlled by RBI. These are
   - Purchase companies
   - Leasing companies
   - Investment companies
   - Finance companies

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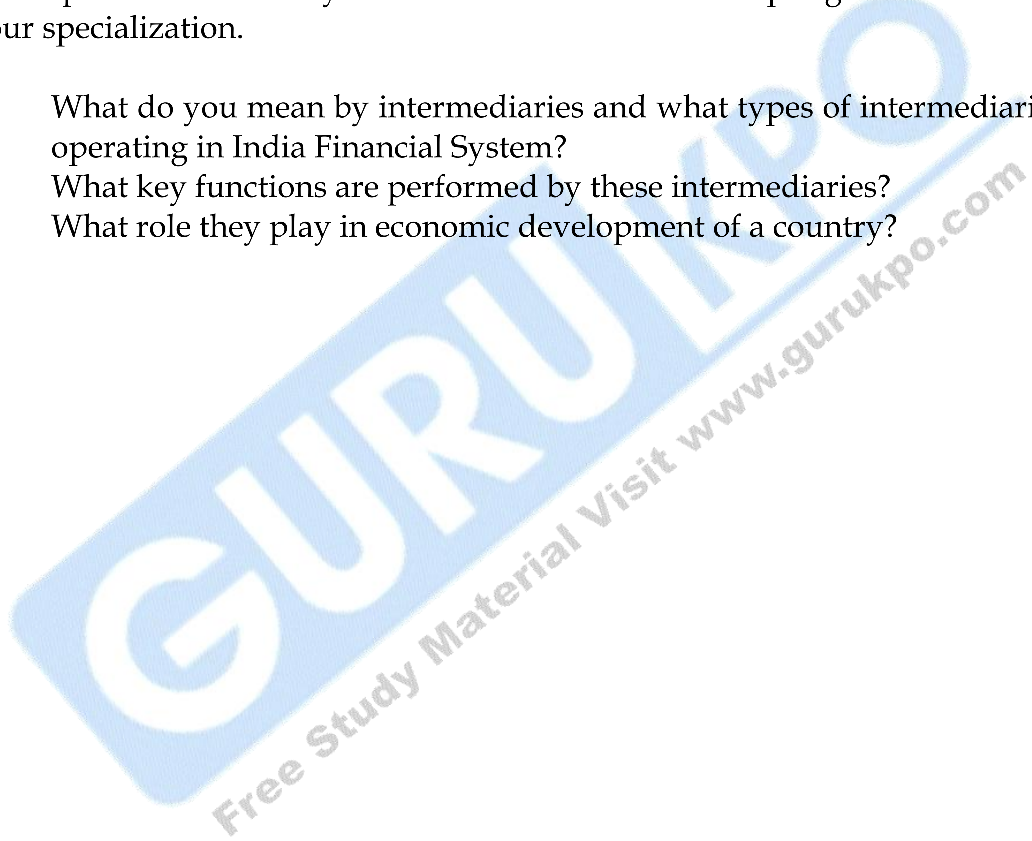
Case Study

On Financial Intermediaries

Financial Intermediaries are considered as an important component of Indian Financial System. They play a crucial role in collecting savings and convert them in to investments to meet the needs of those who are in need of funds for growth and development. Further these Intermediaries plays a key role in economic development of a country. You are a student of MBA opting finance as areas of your specialization.

1. What do you mean by intermediaries and what types of intermediaries are operating in India Financial System?
2. What key functions are performed by these intermediaries?
3. What role they play in economic development of a country?



Chapter – 2

Financial institutions and economic development

Q.1 Explain in brief the role of financial system in economic development.

Ans. Economic development of any country depends upon the existence of a well organized financial system. A financial system is a integrated set of financial institutions (financial intermediaries), financial markets, financial assets/ instrument and financial services which facilitate transfer and allocation of funds efficiently and effectively. Through this system, funds flow from areas of surplus to areas of deficit. The financial system is concerned about money, credit and finance

Financial system provides an ideal linkage between depositor & investor, thus encouraging both savings and investment. It also promotes efficient allocation of financial resources for socially desirable and economically productive purposes and thus influences both quality and pace of economic development.

Role of Financial System in Economic Development- Economic development is generally characterized by rise in national and per capita income. This improvement in income in turn facilitates:

- larger savings
- Increase capital formation &
- Greater Technological development

These larger savings and capital formation leads to:

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- Rise in per capita availability of capital resources
- Improvement in skills due to technological development in skills due to technological development
- Efficiency and earning power of labour
- Better organization of production
- Development of means of Transport & communication
- Rise in standard of health and education and expectation of life
- greater leisure and increased recreation facilities
- Growth of financial institutions & widening mental horizons of people

The essence of economic development lies in growth of output or real income per head of population. Economic growth means transformation of an economy from the state of:

- Under developed to a state of development
- From a agrarian to a highly industrialized society
- From a low saver to high saver
- From a predominantly rural to predominantly urbanized society

The development of economy and transformation of economy as indicated above is largely due to influence of financial system. The adequate supply of finance not only increases national income but also leads to greater employment opportunities, improvement in the standard of living and social welfare. In fact all three crucial components of production i.e. man, material and money have to bring desired results. Human capital and physical capital can be bought and developed with money. In real sense, money, credit & finance are the life blood of economic system and are part of financial system. Hence, a well developed financial system can contribute significantly to the acceleration of economic development.

Q.2 What do you understand by financial markets? What is their role in financial system.

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Ans. Financial Markets are the centers which provide facilities for buying and selling of financial claims & services. The participants in the financial market are financial Institutions, brokers, dealers, borrowers and investors. They are inter linked by laws, contract and communication net work. Financial markets can be divided in two parts:

- Primary market- Which deals in new financial claims or instruments. It is also called new issue market.
- Secondary market- Which deals in securities which are already issued by companies

Primary markets mobilise savings and supply additional capital to the companies. However, secondary markets do not supply additional capital but indirectly help the companies and investors in providing liquidity.

Financial markets are also classified as money market & capital market. The money market deals in short term claims with a maturity period of less than a year and capital market deals in long term claims and securities.

Financial markets can also be classified as

- organized & unorganized
- formal or informal
- Domestic or foreign markets

Functions of financial markets- Main function are

- To facilitate creation and allocation of credit and liquidity
- To serve as inter-mediary for mobilization of savings
- To assist the process of balanced economic growth
- To provide financial convenience
- To cater to the various credit needs of business houses.

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Though financial market can be classified in to different classes as discussed above, two main are capital market and money market. These two falls in the category of organized market as there are standard rules and regulations governing their financial dealings. These markets are subject to strict supervision and control by RBI and other regulatory bodies. A brief explanation about these two is given below:

(1) **Capital market-** Which facilitate borrowing and lending of long term funds. It consists of channels through which saving of community are made available for industrial and commercial enterprises and public authorities. It is concerned with those private savings, individual as well as corporate that are turned in to investments through new issues and new public loans floated by government and semi govt. bodies. Capital markets can be classified mainly in to three i.e.

   (a) Industrial security market
      - Primary market
      - Secondary market
   (b) Govt. security market
   (c) Long term loan market

(2) **Money market-** A market for short term money and financial assets that are near substitutes for money. Short term period generally means period up to one year and near substitute for money means quick conversion in to money with minimum transaction cost. Its primary function is to facilitate adjustment of liquidity position of commercial banks, business corporations and other financial institutions.

   some of the important money market instrument are:

   - Call notice money
   - Interbank money
   - Treasury bills
   - Certificate of deposits
   - Commercial paper

Role/ significance of financial markets in financial system– Financial system is a broad term which include financial markets, financial intermediaries, financial

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assets/ instruments and financial services. Financial markets attract individual as well corporate savings and convert them in to investments for the growth of economy. In fact, the whole financial and credit needs of all key sectors of economy are channelized through intermediaries operating in the financial market. While money markets role is to arrange short term funds and maintain liquidity, capital market helps in arranging and meeting long term needs of all key sectors of economy. These markets protect the interest of savers on the one hand and provide money to those who need money. Hence financial markets play a crucial role in the economic development.

Q.3 What do you mean by govt. intervention in financial system? Which are the key govt. agencies for this purpose?

Ans. Govt. intervention means control/ regulation by regulatory authorities created by Govt. through a statute for exercising control on some specific institutions working in the Indian financial system. The key regulatory bodies are:-

I- Reserve Bank of India (RBI)

RBI is central bank of the country came in to being through RBI act 1934 which was made effective from 1-4-1935. As a Govt. body, RBI through RBI act. 1934 & Banking Regulation Act 1949 exercises control ever entire banking industry (consisting of commercial banks and cooperative banks) through following key powers:

<u>Power of RBI</u>

(i) Supervision; and control over commercial and cooperative banks relating to licensing and establishment.

(ii) Branch expansion

(iii) Liquidity of their assets

(iv) Management and methods of working, amalgamation , reconstruction and liquidation

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(v) RBI is authorized to carryout periodical inspection of banks and call for returns and necessary information from them

RBI acts as banker's bank as well as protects the interest of depositor through inspection of banks.

Functions of RBI – Key functions performed by RBI are

(i) Maintain monitory stability

(ii) maintain financial stability and ensure sound financial institutions

(iii) Maintain stable payment system so that financial transactions can be safely and efficiently executed

(iv) Promote development of financial infrastructure of markets and systems

(v) Ensuring that credit allocation by financial system broadly reflect national economic priorities and societal concern.

(vi) Regulate overall money & credit in the economy with a view to ensure reasonable degree of price stability.

II- Security & Exchange Board of India (SEBI)

The SEBI was made a statutory body by SEBI act 1992 to monitor and regulate capital market activities and to promote healthy development of capital market. Its basic aim is to protect the interest of investors in securities by properly regulating securities market. It regulates the working of stock exchanges

Powers & functions of SEBI (under section II (i) of SEBI act. 1992)

(i) registering and regulating working of

- Stock brokers, sub brokers share transfer agents
- Bankers to an issue, registrars to an issue
- Transfers of trust deeds
- Merchant Bankers, underwriters
- Portfolio managers, investment advisors &

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- Other such intermediaries who may be associated with securities market in any manner

(ii) Registering and regulating the working of collective investment schemes including mutual fund

(iii) Prohibiting fraudulent and unfair trade practice relating to security market and inside trading in securities

(iv) Promote investors education and teaching of intermediaries in security market

(v) Regulating substantial acquision of shares and takeover of companies

(vi) Calling for information, undertaking inspection, conducting enquires and audit of stock exchange, intermediaries and self regulatory organization in the stock market

(vii) Promoting such functions and exercising such powers under the provisions of Capital Issue (Control) Act. 1974 and Securities Contracts (Regulation) Act. 1956 as may be delegated to it by central Govt.

(viii) Power of levying fee and other changes

(ix) Conducting research for above purposes

III- Insurance Regulatory & Development Authority (IRDA)

IRDA came in to being in 1999 under IRDA Act to protect the interest of insurance policy holders and to regulate and promote an orderly growth of insurance industry and all intermediary companies dealing with life and non-life insurance in the financial system of India.

Powers & Functions of IRDA (Under section 14(1) of IRDA Act.)

(i) Issuance of certificate of registration to all insurance companies and renew, modify, withdraw, suspend or cancel such certificate.

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(ii) Protect interest of policy holders

(iii) Specifying Qualification and code of conduct and training for insurance agents, surveyors and loss assessors

(iv) Levying fee and other charges under the Act.

(v) Calling information from, undertake inspection, enquiry investigation, audit of insurers, intermediaries connected with insurance business

(vi) Specifying books to be maintained and statement of accounts to be submitted by insurance and other intermediaries

(vii) Regulating investment of funds by insurance companies

(viii) Supervising functioning of tariff advisory committee

(ix) Specifying percentage of rural insurance business by the insurer

(x) Exercising other powers as may be prescribed by Govt.

At the level of central Govt., in the ministry of finance, there is a Dept. of Banking & Insurance which monitors/regulate banking & insurance sector

Case Study
On Financial Systems & Economic Development

Presently, many countries in the world are passing through recessionary trends. Some of the reputed international Rating Agencies of world have reduced the rating of some Indian banking & financial institutions. However, in spite of slow down of industrial growth rate and inflationary pressure, some experts holding key positions in Govt, are often commenting that Indian Financial System is very strong and because of this, recessionary trends in many foreign countries has either no impact or very little impact on Indian economy.

1. As a student of MBA (Finance) what logic you would give in support of our strong financial system due to which our economy is not very must effected due to recessionary trends in other countries?

2. What are the impacts of globalization on our economy?
3. How our strong spiritual cultural heritage & living habits are helping our Indian Financial System in becoming strong?

Chapter – 3

Financial Markets and Instruments

Q.1 Explain in brief money market and capital market & different types of markets under money and capital market.

Ans. Brief explanation of term money market and capital market has been provided in question number six under financial market.

Different types of money market

(i) **Call Money Market-** Also known as inter bank money market. In this, day to day surplus funds mostly of banks are traded. It is a market for extremely short period loans say one day to fourteen days. Such loans are repayable on demand at the option of either the lender or the borrower. Interest rates changes hour to hour or day to day based on the demand and supply of money.

(ii) **Commercial Bill Market-** It is a market where commercial bills or trade bills are handled. In case of credit sale, the seller may draw a bill of exchange on buyer. The buyer accepts it & pays money to seller at later date. The seller has to wait for due date or he can get the bill discounted from a bank. Hence, commercial banks play a key role in market.

(iii) **Treasury Bill Market-** Treasury bills are promissory notes of short term maturity (91 days to 364 days) issued by RBI on behalf of Govt. and is a permanent source of funds for the Govt. to meet Govt. deficits. These treasury bills are issued to public, banks and other financial institution. Financial intermediaries can park their temporary surpluses in these instruments and earn income.

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(iv) **Commercial paper Market-** This CP market was introduced in India in 1990 These CPs can be issued by listed companies; which have working capital of not less than Rs. 5 crores. The maturity period of CPs ranges between 3 months to 6 months and are issued in the multiple of Rs. 25 lakhs with a minimum size of Rs. 1 crore. They are freely transferable by endorsement and delivery.

(v) **Certificate of Deposit Market(CD's) –** The scheme of CD's was introduced by RBI in 1989 to enable commercial banks to raise money/funds from market. These CD's are also issued in the multiples of Rs. 25 lakhs with a minimum size of Rs. 1 crore. The CD's are issued at discount.

(vi) **Short term loan market –** It is a market where short term loans are given to corporate customers for meeting their working capital requirements. Commercial banks play a significant role by providing loans in the form of cash credit and overdrafts.

Capital Markets- Types

(i) **Industrial Security Market-** It is market where industrial concerns raise their capital or debt by issuing instruments like equity shares or ordinary shares, preference shares, debentures or bonds, This market can be sub divided into:

(a) Primary Market or new issue market

(b) Secondary Market or stock Exchange

Primary Market is a market for new issue and hence it is called new issue market. It deals with securities which are issued to the public for the first time. There are three ways through which capital is raised in primary market. These are:

- **Public issue**
- Right Issue

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- Private placement

Secondary market is a market for secondary sale of securities i.e. securities which already passed through the new issue market are traded in this secondary market. Generally, such securities are quoted in stock exchange and it provides a continuous and regular market for buying and selling of securities.

(ii) **Govt. Security Market-** It is market where long term Govt. securities are traded whih are issued by central Govt, State Govt, Semi Govt. authorities like City Corporations, Port Trusts, Improvement Trusts, State Electricity Boards, All india and State level financial institution and public sector organizations/enterprises are dealt in this market. Govt. Securities are in many forms such as:

- Stock Certificates or inscribed stock
- Promissory Notes
- Bearer bonds

Govt. securities are sold through public debt office of RBI. Interest on these securities influences price and yield in market.

(iii) **Long Term loan market** – Commercial banks and development banks play a significant role in this market by supplying long term loans to corporate customers. Long term loan market may further be classified into:

- Term loan market
- Mortgage Market
- Financial Guarantee Market

Term loan Market- In India many industrial finance institutions have been created by central & state Govt. which provide medium & long term loans to corporate customers. Institutions like IDBI, IFCI, ICICI and other state financial corporation's come in this category

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Mortgage Market- Refers to centers which supply mainly mortgage loan mainly to indusial customers against security of immovable property like building.

Financial Guarantee Market – Refers to centres where finance is provided against the guarantee of reputed person in financial circle. This guarantee may be in the form of (i) performance guarantee or (ii) financial guarantee. The performance guarantees covers the payment of earnest money, retention money, advance payments and non compliance of contracts etc. The financial guarantee covers only financial contract.

Q.2 Explain in brief key financial instruments like REPO, TB's, Equity, Bonds & Derivatives.

Ans. **REPO Instruments-** REPO stands for repurchase. Under repo transaction, borrower parts with securities to the lender with an agreement to repurchase them at the end of the fixed period at a specified rate. On the end of period, borrower will repurchase the securities at a predetermine price. The difference between the purchase price and the original price is the cost to the borrower. This cost of borrowing is called "Repo rate" which is little cheaper than pure borrowing. A transaction is called a repo when viewed from the prospective of seller of securities and reverse repo when described from the point of view of the suppliers of funds Thus whether a given agreement is termed as Repo or Reverse Repo depends largely on which party initiated the transaction. Repo transactions are conducted in the money market to manipulate short term interest rate and manage liquidity levels. In India repos are normally conducted for a period of 3 days. The eligible securities for the purpose are decided by RBI. These securities are usually Govt. promissory notes, treasury bills and public sector bonds.

Treasury Bills (T.B) A T.B. is a promissory note issued by RBI for Govt. under discount for a specified period stated there in. The Govt. promises to pay the specified amount maintained there in to the bearer of instrument on the due date.

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The period does not exceed a period of one year. It is purely finance bill since in does not arise out of any trade transaction. TBs are issued by RBI on behalf of the Govt. for meeting temporary Govt. deficits. The rate of discount on TB is fixed by RBI from time to time It is the lowest one in the entire structure of interest rates in the security because of short term maturity and high degree of liquidity and security. On the basis of period, TB's may be classified in to three i.e. 91 days TB, 182 days TB and 364 days TB.

Investments in TB's are highly safe since the payment of interest and principal are assured by the Govt. Investment is highly liquid as they can be converted in to eash any time at the option of investor. However, yield on TB's is low.

Equity – Mainly are of two types

(1) **Ordinary shares**:- They provides basis for permanent capital and are owners of the company and bear the risk. They get dividend only after preference shares and in case of wind up, they are the last recipients of money. They have voting right, and hence they manage the company by electing board of directors. They are actively involved in forming policies of company.

(2) **Preference share** :- These share holders are those who have preferencial right in respect of payment of dividend and repayment of capital in case of winding up of company. Rate of dividend is fixed and they have restricted voting rights. There are different types of preferencial shares.

- cumulative or non-cumulative
- Redeemable non-redeemable
- Participating non-participating shares
- Convertible and non-convertible preference shares.

Bonds- Bond is a debt instrument bearing interest on maturity (maturity is more than a year). Interest is specified which is also known as coupon rate.

Type of Bonds

(i) On the basis of reliability of coupon

(a) **Zero coupon bonds or Deep Discount Bond :-** These are issued at discount and on maturity, full face value is paid. Difference between these two is interest or coupon on the bond

(b) **Floating rate bond:-** coupon rate is not specified which used to change with reference to bench marke rate. They are also known as

- Variable rate bonds or
- Adjustable rate bonds
-

(ii) On the basis of maturity

(a) **Callable bond:-** Holder has right to change maturity and issuer has to pay the amount before maturity if holder so likes.

(b) **Putt able bond:-** Holder has right to put option to redeem before maturity and purchase from issuer with high rate coupon.

(c) **Convertible bond :-** Holder has a right to convert bond in equity in ratio fixed at the time of issue. This bond may be fully or partly convertible in equity

(iii) On basis of principal repayment

(a) **Amortizing bonds:-** Repayment schedule is fixed in such manner that every year part amount is repaid and at maturity, last installment is repaid

(b) **Bond with sinking fund provision:-** creating sinking fund for redemption and out of this fund, retiring bond every year.

Financial Derivatives:- They provide risk reducing mechanism in the present volatile market atmosphere-

These financial derivatives are as follows:

(i) **Forward-** A forward contract refers to an agreement between two parties to exchange an agreed quantity of asset for each at a certain date in future at a predetermined price. Asset may be currency, commodity, instrument, for example 'A' agrees to buy 50 bales of

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cotton from 'B' on 1-12-2010 @ Rs. 1000 per bale for Rs. 50000/- 'B' has to supply 50 bales on 1-12-2010 @ Rs. 1000 bale. This is known as "forward rate contract"

(ii) **Futures:-** A contract similar to forward contract except the fact that it is completely standardized and is legally enforceable by law. Here, contact is through organized exchange and some initial amount is required to be deposited with organized exchange so as to ensure that contact would be fulfilled. All other features are like forward contract.

(iii) **Options:-** In the volatile environment, risk of heavy fluctuations in price of assets is there. Option is yet another tool to manage such risks. It gives the buyer an option to buy or sell an asset at a predetermined price on or before specified date in future. The price so determined is called "strike price" or "exercise price". Types of options are:

- **Call option-** The seller is under obligation to sell the asset in case buyer exercise the option to buy.
- **Put option-** Here buyer is under obligation to buy if seller exercise the option

(iv) **Swap:** Swap is yet another exciting instrument which is a combination of forwards by two counter parties. It is arranged to reap fruits arising from fluctuations in market i.e.

- Currency market
- Interest rate market.

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Q.3 Explain in brief four key characteristics of financial instruments i.e. liquidity, Maturity, safety and yield.

Ans. Investor while taking decision to invest amount through any financial instrument has four key elements in mind i.e. liquidity, safety, maturity and yield. A brief explanation about each of these elements is given below:

(i) **Liquidity**:- Liquidity is most important consideration which means easy convertibility in to cash without any loss of time, at minimum transaction cost and without following complicated procedural hurdles. An investor would also consider period of investment based on his need of cash out of that investment i.e. liquidity. Hence, need for liquidity would also determine period of investment in a financial instrument.

(ii) **Safety**:- Means haw safe is the investment in that financial instrument. Safety refers to elimination of risk factor to an optimum extent. An investment may be fully secured, partly secured or uncured. An investment in equity shares is not secured as dividend would be paid only if the company earns profit. But, in case of debenture, the investor is going to get interest irrespective of profit or loss of the company. Hence, a investor who is not prepared to bear any risk would give top priority to safety and for this he may even agree for low return/yield. Deposit in nationalized banks is considered safest though interest may be very low. Interest in saving deposit is merely 4% and in current deposit there is no interest.

(iii) **Maturity**- Refers to the period which may be short term (less than a year) medium term (more than a year but less than 3 years and long term (for more than 3 years). Hence decision to invest the amount would be taken keeping in view maturity requirements of funds. Generally longer period investment earn better return as compared to short period investments.

(iv) **Yield** – It refers to return on investment made in the form of interest, dividend, coupon etc. The chance of higher yield are their in risky instruments. Here the same formula would apply i.e. higher risk higher gain.

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Case Study
On Financial Instruments

After passing MBA, you have been appointed as an Asstt. Manager in a big Export House on a monthly salary of Rs. 40,000/-. Being unmarried, you are living in a P.G. and at the end of year, you found that you could save Rs. 2 Lakh which you want to invest in diversified financial instruments.

1. Which types of financial instruments are available in market in which savings can be invested?
2. While investing, what would be your investment objective and what considerations you would keep in mind, while taking an investment decision?
3. What different types of risks you would like to avoid in this regard?

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Chapter – 4

Concept of Strategic Decisions

Q.1 What do you mean by strategy and strategic decisions ? What are such decisions pertaining to finance area ?

Ans Strategy is a comprehensive plan to achieve organizational goals. Such a plan is prepared keeping in view:

- Internal strengths of company &
- Challenges of external environment

Such strategic plan is formed after the determination of long term goals and objectives of the organization and to make plans for allocation of resources and implementation of projects for achieving set goals..

The process of strategic decision making involves the process of deciding long term:

- Mission
- Objective
- Swot analysis
- Identification of thrust areas

Strategic decision making helps managers in identifying the sources of funds from where they can procure funds at lowest cost and employ them in areas which provide best return. It is a decision regarding management of funds and resources and finding out best activities which can generate profit and value addition to the organization.

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In today highly technologically advanced business world, advanced statistical techniques such as regression analysis is used to verify and refine financial information for decision taking rather than mere financial depending on financial ratios.

The key tasks associated with the decisions related to strategic finance decision are.

1. Analysis of financial problems in individual firm
2. Analyzing the sources of low cost of funds.
3. Analyzing profitable business activities

The key objectives of strategic decisions pertaining to finance are:

- Maximizing profit
- Maximizing share holders wealth
- Minimizing risk
- Maintaining control to rationalize costs
- Proper forecasting and measuring results

Main tools and techniques of strategic financial decision making are:

- Ratio analysis
- Portfolio analysis
- Valuation of firm
- Trend analysis

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Q.2 Explain in brief the concept and procedure to be followed in merger & acquisition. Give examples of some Indian cases

Ans. **Merger:** The term merger refers to combination of two or more companies in to single company and this combination may be through absorption or consolidation. When one company absorbs another company, it is called absorption where as when two or more companies combine to form a new company, it is known as consolidation. In legal parlance, merger is also referred to amalgamation.

Indian Companies Act 1956 Govern the merger of companies in to a single economic unit and the scheme of merger is approved by all or prescribed majority of share holders of the merging company as well as merged company in their respective general meetings and is also sanctioned by the court.

Kinds of merger:

i. **Horizontal merger:** When two firms engaged in the same business line merger together, it is known as horizontal merger. This form of merger results in the expansion of business of firm's operations in a given product line and the same time eliminates competitor.

ii. **Vertical merger:** When two firms working in different stages of production or distribution of the same product join together, it is called vertical merger. The economic benefits of this type of merger come from firms increased control ove the acquisition of raw material or distribution of finished goods.

iii. **Conglomerate merger:** It relates to merger of two firms engaged in totally unrelated business i.e. business are not related to each other horizontally or vertically. A conglomerate may have operations in manufacturing, banking, fast food restaurant etc. This form of merger results in expansion of business in different unrelated lines with a aim to diversify the business.

Acquisition:- Acquisition refers to effective working control by one company over another. This control may be acquired through purchase of majority of shares carrying voting rights exercisable at general meeting or controlling the composition of board of directors of the company. The control over management of another company can be acquired through either a friendly take over or through forced or unwilling acquisition. But generally when a company takes control of another company through mutual agreement, it is called acquisition.

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Merger and acquisition play a vital role in corporate financial management. This M&A is resorted by many companies which are seeking entry in new markets, acquire and consolidate strength, expand customer base or cut competition. It is done for revenue enhancement and cost savings.

Motives for merger & acquisition

- Economics of large scale business
- Elimination of competition
- Take advantages of technical and managerial talent
- Desire to enjoy monopoly power
- Patent rights
- Desire of unified control and self- sufficiency
- Personal ambitions
- Government pressure
- Tax benefits/implications
- Growth & stabilization

Some latest Indian cases/examples of merger/ acquisition

- Recently, state Bank of Sawrashtra has been marged with state bank of India and state bank of Indore is in the process of merger with state bank of India
- Latest merger in offing is merger of Bank of Rajasthan with ICICI bank and exchange of share of both has also been decided. As per news appearing in papers, ICICI has decided to issue 25 shares against 118 shares of Bank of Rajasthan.

Q.3 What do you understand by valuation of exchange rate mechanism ?

Ans. The price of one currency in terms of another is called exchange rate. The foreign exchange market is a market where currency of one country is exchanged for the currency of another country. In international market, there are many factors which

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influence this exchange rate such as political and legal regulations, change in interest rate and inflation rate etc. This makes conversion and valuation of exchange rate risky and makes it important to understand the dynamics of exchange rate mechanism.

Foreign exchange market involves central bank, brokers/dealers, commercial banks and investors. The exchange rates are determined by the supply and demand of currencies which are traded in foreign exchange market. There are two types of rates prevalent in the market.

(I) **Spot Exchange rate :-** Is the rate at which currency can be bought or sold for immediate delivery which is within two business days. Thus, it is current rate at which one currency can be immediately converted in to another currency. Generally in the spot exchange market, two types of spot rates are quoted i.e.

a) **Ask price –** is the rate at which foreign currency can be purchased from the dealer in exchange of domestic currency

b) **Bid price –** is the rate at which the dealer is ready to pay in domestic currency in exchange of foreign currency

In practice, dealer quotes two way rates one for buying and other for selling foreign currency, for example, a dealer quotes Rs. 45.60/ Rs. 45.93 per US Dollar. It means, bank is willing to buy dollar for Rs. 45.60 and sell US Doller for Rs. 45.93 Buying rate is bid rate and selling rate is ask rate. The difference between these two rates is known as spread of dealer.

(II) **Forward Exchange Rate :-** It is the rate which is fixed today but the settlement of transaction takes place at some specified date in future. Hence, it is rate which is agreed by parties and remain fixed for the contract period regardless of fluctuations in the spot exchange rates in future. So the exchange is agreed today though the actual transaction of buying and selling will take place on a future specified date. This time period may be one month, 3 months or six months.

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Forward rates are expressed in two ways in international market i.e. at premium on spot rate and at a discount from spot rate. If forward rate is above the spot rate it is known as forward premium. If forward rate is below spot rate, it is known as forward discount.

Arbitrage in foreign exchange market:- It is act of buying currency from one market having lower price and selling it in higher priced market. The difference between the two market rates provides opportunity to arbitrageurs/ operators to earn profit without any risk.

Cross Rates:- Is an exchange rate between the currencies of two countries which are not quoted against each other but are quoted against one common currency. There are many currencies which are not freely traded in foreign exchange market Most of such currencies are however quoted against US Dollar.

Theories of exchange rate:- There are various factors which differentiates the exchange rate of different currencies. There are several reasons for this exchange rate difference. Various factors or theories responsible for variation in exchange rates are as follows:

(i) **Purchase Power Parity (PPP) Theory:-** This theory states that goods of equal value in different countries could be equated through an exchange rate. As per this theory, value of currency in one country is determined by the amount of goods and services that can be purchased with a unit of currency i.e. its purchasing power. If there is more than one currency, then exchange rate between two currencies must provide the same purchasing power for each currency and this condition is called purchasing power parity. So, the PPP says that exchange rate sets in such a way that the same basket of goods will sell at the same price in different countries

(ii) **Interest Rate Parity (IRP) Theory:-** This theory states that the premium or discount on one currency in relation to other should reflect the interest rate differencial between the two countries. That is, the difference between the forward rate and spot rate is just enough to off set the difference between the interest rates in two countries.

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Q.4 What do you understand by term "factoring" and forfeiting? Also explain the difference between these two terms.

Ans. Factoring can be defined as an arrangement between financial institution or banker(factor) and a business concern (seller/supplier) selling goods or providing securities to trade customers where by factor purchases book debts and administers the sales ledger of the supplier. In other words, the outright sale of accounts receivables is known as factoring.

In this mechanism, factor purchases the client's trade debts/accounts receivable either with recourse (where risk of non payment by debtor is of factoring agency). In this process, client is immediately paid around 80% of trade debt and remaining 20% payment is done on recovery of debt by factor. Factoring agency gets commission/ fee for performing the duties on behalf of client.

Main types of factoring are:

1. **Recourse or non recourse factoring** – In case of recourse, the risk of nonpayment by debtors is not of factor but in case of non recourse, such risk is assumed by factor.
2. **Maturity factoring –** In this, the factor does not provide immediate cash payment to the client, but he pays cash as and when amount of debt is collected from debtor.
3. **Bulk factoring or invoice factoring –** in case of bulk factoring, the factor simply collects the debt on behalf of client and the work like maintaining sales sedger or credit control is done by client. In case of invoice factoring, the factor provides finance to client by telling the client about this arrangement. Hence, this is also known as confidential invoice discounting.
4. **Agency factoring –** in this case, factor has to provide finance and assure credit risk and client has to undertake maintenance and collection work.

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5. **International factoring –** Here the factor provides services to international business by providing factoring services to exporting agency.

FORFAITING

Forfaiting is another source of financing against receivables like factoring. This technique of forfaiting is mostly employed to help an exporter for financing goods exported on a medium term basis. It is a form of financing of receivables pertaining to international trade. In this process of forfaiting, the exporter gives up his right to receive payment in future under an export bill for immediate cash payment by forfaiter. The cash payment involves 100% of the amount of bill less discount charges. It is a unique medium which can convert a credit sale into a cash sale for an exporter.

In this process of forfaiting, four parties are involved which are:

(i) The Exporter – One who immediately converts the credit into cash. He is also referred as client.

(ii) The Forfaiter – One who takes the responsibility of collection of debts.

(iii) The importer – One who has to pay the debt. Also known as debtor.

(iv) The bank – One who makes payment on maturity to the forfaiter on presentation of bill of exchange. Also known as guarenter of the importer.

Advantages of forfaiting

(i) Exporter gets better liquidity.
(ii) No risk to exporter for non settlement of claim.
(iii) No risk of exchange rate fluctuations.
(iv) Most simple and flexible in nature
(v) Provides specialized service in credit management

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Difference between factoring and forfaiting

Factoring	Forfaiting
1. It refers to domestic trade	It applies to international trade only
2. Done for short term financing	It is for medium term financing
3. Invoice of client is purchased	Export bill is purchased
4. It may be with or without recourse to client.	It is without recourse to client.
5. Around 80% to 85% of total invoice price is paid.	Forfeiter pays 100% of the value of export bill less discount.
6. Broader term which also includes maintenance of sales ledger, advisory services etc.	Mainly concentrates on collection of debt.

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Q.5 Explain in brief the term "Securitization" and its whole process..

Ans. Securitization (s) refers to the process of liquidating ill-liquid long term assets like loans/receivables of financial institutions like banks by issuing marketable securities against them. It is a technique by which long term, not negotiable and high valued financial assets are converted into securities of small value which will be traded in market.

Through this process of 'S', banks can remove long term assets from balance sheet by replacing them with liquid cash through issue of securities against them. In these long term assets, funds of banks are blocked unnecessarily for long term. Now this is readymade solution for them. This 'S' helps in recycling of funds at reasonable cost and with less credit risk. This process of 'S' provides liquidity

through tradable financial instruments. Entire transaction of 'S' is carried out in asset side of balance sheet i.e. one asset (ill-liquid) is converted into another asset cash.

Hence 'S' is nothing but liquidating assets comprising loans and receivables of an institution though systematic issuance of financial instruments. In the operational mechanism of 'S', following parties are there.

(i) Originator – The bank or financial institution which decides to go for 'S'

(ii) Special purpose vehicle (SPV) or a Trust – The institution which is ready to help originator by outright buying such assets.

(iii) Merchant banker or Investment Banker – They act as SPV

(iv) Credit Rating Agency – Which rates the 'S' assets.

(v) Servicing agent or receiving & paying agent – An agency which collects money from 'S' assets. Even originator can take this responsibility.

(vi) Original borrower or obligor – Principal debtor of 'S' assets.

(vii) Prospective Investor or buyers of securities issued by SPV or Trust buying 'S' assets.

Various stages involved in Securitization are:

(i) Identification – Originator has to identify assets to be securitized of homogeneous nature considering their maturity, interest rate, frequency of payment and marketability..

(ii) Transfer Process – After identification, selected pool of assets are passed through to another institution i.e. SPV or trust through outright sale or through collaterised loan. This is known as Transfer process.

(iii) Issue process – In this stage, SPV issues securities to investors in the form of securities of smaller values. These securities are sold to investing public. These securities are called :

"Pay through certificates"

"Pass through certificates"

The repayment schedule of such securities is fixed in such a manner that it matches with repayment of securitized assets.

(iv) Redemption stage - The repayment of interest and principal amount of securities issued is facilitated out of collections made by SPV from 'S' assets. For this purpose, collection agents are appointed on commission basis or originator does this work of collection.

The credit rating agencies rate such securities issued by SPV to facilitate their easy marketability.

The Merchant bankers play key role in this process of 'S' by way of acting as :

- SPV
- Underwriting issue of securities by SPV
- By undertaking issue Management of securities to be issued by SPV
- Structuring issue of securities and ensuring completion of legal formalities for such issue.

Two keys parties – Whose role is crucial in this whole process of securitization are

(i) Original borrowers : Who have to fulfill their commitments of paying the loan & interest taken from bank.

(ii) Investing public : who are buying the securities issued by SPV.

The following type of assets are considerable suitable for securitization .

- Term loans to financially sound/reputed companies.
- Receivables from Govt. Depts/Companies.
- Credit card receivables.

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- Hire purchase loans like vehicle loans
- Lease finance
- Mortgage loans

Advantages of Securitization :

1. Additional sources of funds to originator
2. Greater profitability – Through recycling of funds, increase business turnover.
3. Raises/Enhances – Capital adequacy ratio (CAR)
4. Spreading Risk – Amongst institutions like SPV, Investor public, Merchant banker.
5. Helps originator to have easy access to security market.
6. Better rate of return
7. Avoids idle capital
8. Securities issued are better than traditional securities as they are backed by securitized assets.

Due to advantages of securitization, there is a vast scope for commercial banks to go in for securitization.

Another Dimension of Securitization is to reduce mounting NPA's under SARFAESI ACT 2002 which is explained below ;

Securitization is the process of transforming the assets of a lending institution in to negotiable instrument. It means acquisition of financial assets by a securitization or reconstruction company (SCRC). This process is resorted to reduce large non-performing assets of a bank or financial institution buy SCRC. This is a process where non liquidated financial assets are converted into marketable securities which can be sold to investors. It is a process of converting receivables and other assets in to securities and security receipts that can be placed in market for trading.

On acquisition of financial assets, the SCRC becomes the owner of financial assets and steps into the shoes of lender bank or financial institution. The RBI is the regulatory authority for SCRC which is company registered under the companies Act 1956 for the purpose of securitization. It needs registration with RBI under SARFAESI ACT 2002.

Benefits of Securitization –

1. **Positive effect on balance sheet –** Securitization is an accounting arm related to removal of debts from the balance sheet of a bank/financial institution. A bank would find it easy to be in confirmity with the capital adequacy norms laid down by RBI.
2. **Increase in income –** Bank can earn income in the form of service charges from selling the loan and than for servicing new loans.
3. **More loans with the same liability –** The cash flow obtained by selling the old debt in the form of securities can be used to lend funds further at a profit to bank. Hence against same amount of liabilities, lending of banks increases.

Q.6 Explain in brief concept of creation of share holders value and measuring this value. Also explain important theories for measuring this value.

Ans. Creating value for share holders is a windely accepted corporate objectives and as such corporate executives are under great pressure to measure, manage and report on creation of share holders value. Vaule is created when management generates revenue ever and above costs. costs come from four sources i.e. employees wages and benefits, material supplies, economic depreciation from physical assets, taxes and the opportunity cost of capital. Share holders expect management to generat value over and above the cost of resources consumed

including the cost of using capital. If investors of capital do not receive a fair return to compensate form the risk they are taking, they will withdraw this capital in search of better return.

Wealth creation refers to changes in the wealth of share holders on periodic (annual) basis. Changes in the share holders wealth are inferred mostly from changes in stock prices, dividends paid and equity raised during the period since stock prices reflect investor expectations about future cash flow creating wealth for shareholders require that the firm undertake investment decision that have a positive net present value (NPV)

There is a subtle difference value creation and wealth creation. While the value perspective is based on measuring value directly from accounting based information with some adjustments the, wealth prespective relies mainly on stock market information.

Approaches for measuring share holders value:

(1) **Marakan Approach**:- Marakan Associates an international management consulting firm founded in 1978 has done some pioneering work in the area of value based management. According to this model, share holders wealth creation is measured as the difference between market value and book value of a firms equity. The book value of firms equity, 'B' measures approximately the capital contributed by the share holders, where as the market value of equity "M' reflects how productively the firm has employed the capital contributed by the shareholders as assessed by stock market. Hence, the management creates value of shareholders if M exceeds B, depreciates value if M is less then B, and maintains value if M is equal to B. According to this model, market to book value ratio is function of return on equity, the growth rate of dividend and cost of equity.

(2) **Alcar Approach:-** Alcar group Inc. a management and software company has developed an approach to the value based management which is based on discounted cash flow analysis. In this approach, one estimates future cash flows of the firm over a reasonable horizon, assigns a continuing value at the end of horizon, estimates the cost of capital and then estimates the value of the firm by calculating the present value of these estimated cash flows. Since the computation

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arrives at the value of the firm, the implied value of firms equity can be determined by subtracting the value of current debt from the estimated value of the firm. This value is the implied value of the firm.

To estimate whether the firms management has created share holders value, one subtracts the implied value at the beginning of the year from the value estimated at the end of year, adjusting for any dividend paid during the year. If this difference is positive (i.e. estimated value of equity has increased during the year) management can be said to have created share holders value.

(3) **McKinsey Approach:-** McKinsey & co. a leading international consultancy firm has developed an approach to value base management. It is an approach where by the companies overall aspirations, analytical techniques and management process are all aligned to help the company maximize its value by focusing decision making on the key drivers of value. The key steps in this approach of value based maximization are as follows:

- Ensures the supremacy of value maximization
- find the value drivers
- Establish appropriate managerial processes
- Implements value base management philosophy.

(4) **Economic Value Added (EVA)** – This concept has been developed by consulting firm Stern Steward. EVA is a use full tool to measure the wealth generated by a company for its equity shareholders. It is a measure of residual income after meeting the necessary requirement of funds. This model indicates that EVA is the net result of excess of risk adjusted cost of the capital employed to generate cash flows. The chief features of EVA approach are:

- It is a performance measure that ties directly theoretically to share holders wealth creation
- It converts accounting information into economic reality that is readily grasped by non finance managers.

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- It serves as a guide to every decision from strategic planning, capital budgeting, acquisitions to a operating decisions
- It is an effective tool for investors communication

(5) **The Discounted cash flow approach:** The true economic value of a firm or a business or a project or any strategy depends on the cash flow and the appropriate discount rate. Three main methods mostly used under discounted cash flow approach are:

(i) The first method- uses weighted average cost of debt and equity to discount the net operating cash flow the economic value of a project or business is present value of net operating cash flow + present value of terminal value.

(ii) The second method of calculating economic value explicitly incorporates the value created by financial liverage.

(iii) The third method to determine the share holders economic value is to calculate the value of equity by discounting cash flow available to share holders by the cost of equity

Economic value of equity = Present value of equity cash flow + present value of terminal investment.

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Case Study
On Merger /Amalgamation

To avoid competition, increase market share and to get benefit of economies of scale, many mergers and amalgamations are taking place in corporate world in almost all sectors including banks. The largest public sector bank like State Bank of India has taken a policy decision to merge in itself all subsidiary banks of SBI in SBI proper within next 1-2 years. Some of the subsiding banks of SBI have already merged with SBI and others are in process.

Recently, The Bank of Rajasthan was merged with ICICI though employers of Bank of Rajasthan shown much resentment to this merger.

As a student of MBA (Finance) give your views on the following:

1. What benefits are being visualized by Govt. and SBI in planning for merging subsidiary bank in SBI?
2. What benefits were visualized by ICICI Bank in merging Bank of Rajasthan? To what extent ICICI Bank is getting those benefits and what staff related problems are faced after merger?

Case Study
On factoring

In the Balance Sheet of ABC Company, receivables are amounting to Rs. 2 Crores which contribute 30% of total assets. Most of these receivable have become overdue and management is very much worried on this situation. Out of this amount of receivables of Rs. 2 crores, Rs. 1.2 crores are out of loans taken from a bank at 13% interest. As per agreement with debtors, they have agreed to pay 10% interest on overdue amount.

A factoring agency has approached the company to manage/recover these receivables. This agency would charge 8% commission on the whole amount and prepared to pay 75% amount initially and 25% amount on recovery. This agency is prepared to take full responsibility of recovering the entire amount.

As a consultant to the company, examine the proposal, work out economics of this deal and advise the management of the company to accept the proposal or not?

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Chapter – 5

Analysis of enterprise

Q.1 Explain in brief concept of share holders value creation i.e. SYC, EVA, MVA & enterprise value

Ans. **Share Holders Value Creation (SVC)-** Modern financial management states that a firm must seek to maximize the share holders value rather than making profit. Market value of firms share is the measurement of share holders wealth and thus share holders wealth maximization gained importance. Wealth maximization takes care of economic welfare of the owners or share holders which is reflected in the market price of companies shares. Hence, finance manager should try to increase the market price of shares. He takes in to account the present and future value of 3 elements i.e.

- Total assets (investment decisions)
- Capital investment (financing decisions)
- Dividend distributed (dividend decision)

Combination of these 3 elements together could create maximum value to the share holders. Capital contributed by the share holders is the book value of firm's share and market value of firm's share is share holders wealth. Hence SVC may be defined as the excess of market value over book value per share.

Example: Book value per share Rs. 10/-

Market value per share Rs. 240/-

SVC would be Rs. 230/-

SVC helps the management to concentrate on activities which create value to share holders rather than short term profitability.

Market value Added Approach (MVA) This MVA is one of the three approaches used for creation and analysis of share holders value. The MVA approach measures the changes in the market value of firms equity vis-à-vis equity investment (counting of equity share capital and retained earnings) Hence MVA =Market value of firms equity –equity capital investment.

The MVA approach can't be used for all types of firms. It is applicable only to those firms whose market prices are available and value provided by this approach may be influenced by stock market fluctuations.

Economic Value Added Approach (EVA)

This method is based on the past performance of the firm. The under lying principal in this method is to deter mine whether firm is earning a higher rate of return on the funds invested than cost of such funds i.e. weighted average cost of capital (WACC). If the answer is positive, firms management is adding to the share holders value. On the other hand, if WACC is higher than the earnings rate, the firm's operations have eroded the existing wealth of equity share holders

Hence EVA=(Net operating profit after Taxes –total capital employed x WACC)

Discounted Cash Flow Approach (DCF) This DCF is based on the idea that a company is worth as much as the net present value of cash flows generated by a company for distribution amongst shareholders. It focuses on actual value of cash benefit which is calculated by discounting it with appropriate discount rate (commensurate with the risk of cash flows)

The main draw back of this approach is that it is highly dependent on the skill of forecasting the future value of cash flows. If full and accurate information not available for the business, the valuation is most difficult and unreliable.

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Enterprise value (EV):- Another way of ascertaining the value of the company is to determine the value of enterprise. It consists of market value of company's equity plus market value of companies debt, its pension provisions, minority interest and other claims.

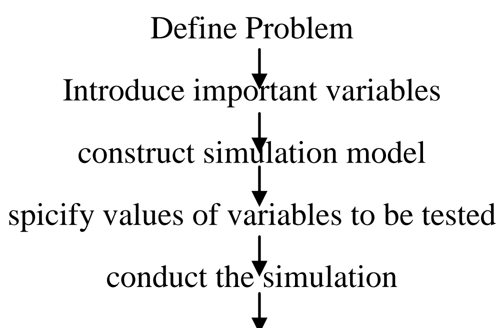
Enterprises Value =Equity value +Market Value of debt +Minority interest +pension provision +other claims.

Q.2 Give a brief account of various corporate financial models.

Ans. Financial modeling is a process of forecasting performance of certain asset using relationship among operating, investing and financial variables. The central aim of all financial modeling is valuation under uncertainty. There are various financial models but two important models are:

(i) **Simulation Model:-** It is a quantitative technique used for evaluating alternative courses of action based on facts and assumptions with a computerized mathematical models in order to represent actual decision marking under conditions of uncertainty. A budget is a comprehensive and coordinated plan in financial terms for the operations and resources of an enterprise for some specified period in future. Due to fast changing environment, budget becomes out dated and as a result company has to prepare revised budget frequently. But if such revision are done manually, it cousumes lot of time and resources. To over come this problem, a corporate financial simulation model can be developed which involves trausforming or converting a company's processes and methods of accounting that are inter related with each other in to a computerized flow chart model.

Process of simulation –



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Examine the results
↓
select best course of action

(ii) **Optimization Model:-** This model plays a very important role in financial decision making. Many computational finance problems ranging from asset allocation to risk management, from optimum investment to working capital and capital expenditure etc. can be solved efficiently using optimization techniques. There are several types of optimization problem like linior quadratic, integer, dynamic, conic, stochastic and robust programming encountered in financial models.

Optimization is a branch of applied mathematics that derives its importance from wide variety of its applications and from the availability of efficient algorithms. Mathematically, it reflect to the minimization or maximization, of a given objective function of several decisions variables that satisfy functional constraints. An optimization models is generally used for the allocation of scarce resources among possible alternative uses in order to maximize an objective function such as profit.

Steps in model building & analysis.

Step I – Problem formulation which presupposes environmental scanning

Step II – Developing/ constructing a typical mathematical model

Step III – Collecting data that are to be based in the model

Step IV – Testing the solution

Step V – Analyse the results

Step VI – Implement the result – monitoring implementation – changing the solution or modifying solution due to necessities felt in implementation.

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Multiple Choice Questions

1. Of the following, which point should be given top priority while selecting suitable investment avenue

   A- Investment Objective   B- Investment Period

   C- Risk   D Return

2. Cheque, draft and bill of exchange are A- Legal tender money, B- Optional money.

3. One Rupee note is signed by- A- Governor RBI, B- Secretary Finance, C- Finance Minister.

4. To control inflation, which of the following rate was often charged by RBI?

   A- Bank Rate,   B- CRR,

   B- C- SLR,   D- Repo Rate

5. How many times were nationalized in the year 1969?

   A- 16,   B-14,

   C-18,   D-20

6. How many more banks were nationalized in 1980?

   A-4,   B-6,

   C-8,   D-5

7. NABARD, EXIM Bank and NHB are development banks and are known as intermediaries. Which type of intermediaries they are

   A- Banking   B- Non-banking

8. Primary and secondary makes come under

   A- Money Market   B- Capital Market

9. How many banks RBI undertakes review of economy and makes policy announcements after this review?

   A- Quarterly,   B- Six Monthly,

   B- C- Yearly,   D- Twice in a quarter i.e. 8 times a year.

10. While making investment which key factor should be given top priority?

    A- Yield,   B- Liquidity,   C- Safety,   D- Marketability

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11. Combine appropriate regularly body like RBI, IRDA & SEBI with following-
A- Merchant Bank, B- Commercial Bank, C- Crop Insurance

12. RBI Act was passed in the year-
A- 1934, B- 1935, C- 1936

13. SEBI came in to being through SEBI Act of-
A- 1991, B- 1992, C- 1993

14. For a big company which of the following group is most important
A- Equity share holder B- Preference share holders
C- Debenture holders D- Creditors

15. A company engaged in manufacturing of electronic goods is merging with a five star hotel. What type of merger it is
A- Horizontal B- Vertical, C- Conglomerate

16. Corporate restructuring includes in itself restructuring of-
A- Financial, B- Organizational,
C- Technological, D- Market
E- Any one or all types

17. Write full form of the following-
1- SCRC, 2- NP V, 3- SYC, 4- EVA, 5- MVA, EV

Answer Key-

1-A, 2- B, 3- C, 4- D, 5- A, 6- C,
7- B, 8- B, 9- D, 10- C,
11- A SEBI, B- RBI, C- IRDA, 12- A, 13- B, 14- B
15- A 16- E

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17- SCRC – Securisation Company & Reconstruction Company
NPV – Net Present Value
SVC - Shareholders Value Creation
EVA - Economic Value Added
MVA - Market Value Aided
EV - Enterprise Value

Key Terms

1. **Amalgamation:** In amalgamation, two or more existing companies merge together or form a new company keeping in view their long term business interest. It is a legal process by which two or more companies join together.

2. **Arbitrage in foreign exchange market** : It is an act of buying currency from one market having lower price and selling it in higher priced market. The difference between these two rates is known as arbitrage or operators profit without any risk.

3. **Bonds**: Bonds refer to debt instruments bearing interest on maturity organizations may borrow funds through securities named bonds having a fixed maturity period and pay a specified rate of interest (coupon rate) on the principle amount to the holders.

4. **Banking and non banking financial intermediaries**: Banking intermediaries include commercial banks and Co operative banks which provide various services. Non banking financial intermediaries are those which do not provide banking services but acts as intermediary in mobilizing sayings from public and investing these savings such as LIC, GIC, UTI etc.

5. **Capital market**: Refers to institutional arrangements for facilitating borrowing and lending for long term securities having maturity period of above one year. This capital market can be further divided in to two i.e. primary market and secondary market.

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6. **Characteristics of financial instrument:** (FI's) most of the FI's are easily transfaraboule, have ready market, possess liquidity, have security value, some have tax benefits, element of risk is there, return of them is in relation to risk and their handling cost is less.

7. **Corporate restructuring:** Is a method of changing the organizational structure in order to achieve strategic goals. It aims at efficient and competitive business operations by increasing the market share, brand power and synergies. It is a process of consolidating business operations for increasing effienciency effectiveness and profitability.

8. **Corporate Financial Models:** Financial modeling is a process of forcasting performances of a certain asset using relationship amongst operating, investing and financial variables. The central aim of all financial models is valuation under uncertainly. There are various models but two important are:
   - Simulation model
   - Optimization model

9. **Cash credit:** It is a primary method through which bank lands money against the security of commodity and debt. It runs like a current account except that the money that can he withdrawn is not restricted to the amount deposited but account holder is permitted to withdraw a certain some called "limit" or "credit facility" in access of amount deposited.

10. **Credit card :** A credit card can be viewed as a payment mechanism which enables the holder of the card to purchase goods and services without paying immediate cash. The issuer of the card gives credit and this card is issued to reputed and credit worthy people.

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11. **Bill discounting:** When holder of the bill does not wait for payment by debtor, goes to the bank and discounts the bill it is known as bill discounting. Bank changes some discount and pays the balance to the holder. On maturity, the debtor makes the payment to bank.

12. **Derivatives:** To avoid risk in financial teansactions, derivations came in to existence. Various type of derivative products are forward contract futures, options and swaps. Generally two simultaneous transactions of sale and purchase are done to reduce risk.

13. **Debenture:** Are principle source of funds to meet long term financial needs. Debenture is debt instrument / document issued by a company as a evidence of debt to the holder and mostly secured by a charge.

14. **Demerger / Divestitures** – Unlike a merger in which all assets are sold, a demerger / divestitures involves selling of some of the assets only. These assets may be in the form of a plant, division, product line, subsidiary or so on. By selling such un productive or non performing asset, the firm is likely to improve it profitability.

15. **Enterprise value:** Another way of ascertaining value of the company is to determine the value of enterprise. It consist of market value of companies equity, plus market value of companies debt, its pension provision, minority interest and other claims.

16. **Economic value added (EVA):** This method is based on the past performances of the firms. under lying principle is to determine whether firm is earning a higher rate of return of funds invested than cost of such funds i.e. Weighted average cost of funds (WACC). If

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answer is positive, firm is adding to share holders value. If negative than firm is eroding existing wealth of share holders.

17. **Factoring:** Is an arrangement between financial institution or bank and a business concern where factor purchases book debts either with or without resource. In other words outright sale of receivables is known as factoring.

18. **Forf aiting:** It is a form of financing of reciverable pertaining to international trade. The purchase is in the form of discounting the entire risk of nonpayment in collection of dues. All risk of collection problems are of purchaser (forfaitor)

19. **Financial markets**- Refers to those centers and arrangements which facilitate buying and selling of financial assets/ instruments. Whenever a financial transaction takes place, it is deemed to have taken place in financial markets. There is no specific place or location to indicate a financial market.

20. **Financial instrument :** Financial asset/ instrument are a liability of issuer towards holder. It is a claim against a person/ institution for payment at a future date and periodic payment in the form of interest or dividend. Financial instruments help the financial markets and the financial intermediaries to perform the important role of channelizing funds from lender to borrower.

21. **Financial services**: Are various services rendered by financial institutions /banks. These services are of two types i.e. fee based and fund based. Fee based services are those where fee is charged for service and fund based are those where services is provided by involving funds such as loans.

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22. **Financial restructuring:** Form of restructuring which deals with restructuring capital base or raising finance for new projects. This involves decisions relating to acquisitions merger, joint ventures and strategic alliances.

23. **Investment :** Is employment of funds with the aim of getting return. Funds are saved from current consumption with the hope to get benefit from these funds in future. There are two concepts of investment i.e. economic concept and financial concept.

24. **Investment Avenues/Alternatives**: Means various areas of investment to be selected by investor keeping in view the period and risk involved and a few other considerations. Various avenues/alternatives may be investment in shares and securities, postal saving schemes, PPF, deposits in banks, LIC Policies, gold, silver, real estate, tax saving schemes such as PPF, NSC, infrastructure bonds residential houses, medical/health insurance etc.

25. **Investment attributes**: Every investor has some specific objectives to achieve through his short/long term investments which are known as attributes. These may be monitary financial such as safety, liquidity, profitability etc. These may be personal such as provision for old age, sickness, marriage of children house construction etc.

26. **Inflation**: Generally refers to rise in prices of goods and services and resultant decreases in the value of money. It is usually measured as a percentage of price index over a period such as consumer price index (CPI) whole sale price intex (WPI) cost of living index (CLI) etc.

27. **Money**: Money is something that is widely used and accepted in transactions involving services transfer of goods and services from one person to other. It is the stuff with which we buy or sell things. Money

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is a medium of exchange, measure of value, store of value, standard for deferred payment and a unit of account etc.

28. **Money Market**: Is a market for short term money and financial assets that are near substitutes of money. Here dealings for a short period ranging from one day up to a year & financial assets can be converted in to cash with minimum cost. Examples of money market are call money market, treasury bill market, certificate of deposit (CD) etc.

29. **Market value added (MVA)** : It is one of three approaches used for creation and analysis of share holoters value. MVA measures changes in market value of firms equity vis-à-vis investments. Hence MVA = Market value of firms equity less equity capital investment.

30. **Mutual fund**: Are special types of institutions which act as a financial intermediary in investment business. They mobilize funds/ savings of small investors and households by selling their own shares known as unit and pass on the return there of to the fund investors for their money involved.

31. **Measuring share holders value**: Share holders expect management to generate value over and above cost of resources consumed including cost of capital various approaches used for measuring share holders value are Marcan approach, Alcar approach, Mekinsey approach and economic value added approach.

32. **Non-banking finance company (NBFC's)** : A NBFC is a company registered under Indian companies Act 1956 and is engaged in business of loans and advances, acquision of shares/stock/bonds/debentures/securities issued by govt. or local authority and engaged in the business of leasing hire purchase, insurance etc. A NBFC cant accept demand deposited, cant issue cheque books and not covered under deposit insurance under DICGC.

33. **Preference shares**: Preference share holders are those who have preferential right in respect of payment of dividend and repayment of capital in case of winding up of a company. Rate of divided and

repayment of capital in case of winding up of a company rate of divided is fixed and they have restricted voting rights.

34. **Portfolio Analysis**: Is the analysis of the organization as a portfolio amongst different portfolios with an objective to maximize returns and value addition against resources deployed. Its objectives are managing risk, managing funds and managing development.

35. **Repo**: Repo stands for repurchase. Under repo transactions, borrower part with the securities to the lender with an agreement to repurchase them at the end of fixed period at a specified rate.

36. **Savings**: Means setting aside money out of current income to earn interest or to meet future needs. These savings may be in the form of cash in hand, deposits in banks or in the form of other investments.

37. **Spot exchange rate**: Is the rate at which currency can be bought or sold for immediate delivery with in two business days. This is current rate at which one currency can be immediately converted in to other currency.

38. **Strategic decision**: Strategic decision making involves process of deciding mission, vision, objective, SWOT analysis and identification of thrust areas keeping in view long term perspective in mind. These decisions are for long term and of permanent nature for managing big corporate.

39. **Strategic decisions pertaining to finance**: Includes identifications of sources of funds from where they can be procured at lowest cost and employ then in arrears which provide highest return. Key goals are maximizing profit, maximizing wealth, minimizing risk, maintaining control and achieving flexibility.

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40. **Securitisation**: Means acquisition of financial assets by a securitization and reconstruction company (SRC) on mutually agreed terms and conditions to reduce large amount of NPA's. It is a process in which illiquid financial assets are converted in to market securities.

41. **Treasury Bill**: Is a promissory not issued on whalf of central govt. by RBI under discount for a specific period stated there in. Govt. promises to pay specified sum to the bearer of treasury bill on due date. These TB's are for 91 days, 182days, and 364days.

42. **Term loans**: Are counter parts of fixed deposits in banks. Banks lend money with repayment in fixed predetermined installments. Such loans are generally given over one year for acquiring long term assets such as plant as machinery, construction of factory, building etc. Financing for automobiles consumer durables real estate also falls in this category.

43. **Overdraft:** Means act of withdrawing from a bank account over and above balance in account. In other words, account holder withdraws more money from his bank account than what has been deposited. For this purpose overdraft limit is sectioned by the banks to such account holders.

44. **Share holders value creation (SVC)** : SVC can be defined as excess of market value over value as per books. For example, book value per share is Rs.10, market value per share is Rs. 240, than SVP would be Rs. 230(Rs 240 less Rs.10)

45. **Value based strategy**: Implies the task of estimating the worth/value of an asset, a security, or business. Generally strategies that could be used by a firm to enhance or create value to share holders are revenue enhancement, cost reduction, optimum utilization of assets and cost of capital reduction.

46. **Interest:** Interest is fee paid on borrowed funds. It can also be treated as rent of money. This fee is compensation to the lender for forgoing other useful investments that could have made with the money loaned.

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47. **Buy onts (MBO & LBO)** : In the corporate world, management buyout (MBO) are modes of acquision of business. It means sale of business to existing management. There is one more term i.e. leveraged buyout.(LBO) which refers to acquisition that is financed by borrowings on secured basic.

48. **Forward exchange rate**: It is rate which is fixed today but the settlement of transactions takes place as some specified date in future. Hence it is rate agreed by parties and remains fixed for the contract period regardless of fluctuations of spot exchange rate in future.

49. **Merger:** Is defined as fusion or absorption of one thing or right in to another. It is an arrangement whereby assets of two or more companies become vested in or under the control of one company. One existing company merges its identify in to another existing company with all assets and liabilities and finally looses its identify.

50. **Regulatory bodies in financial system** : There are three key regulatory bodies in the financial system in India :
    i. RBI – Which regulates banking sector & money market?
    ii. SEBI- Which regulates capital market.
    iii. IRDA- Which regulates insurance sector.

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Roll No. : ______________________

3M6306

M.B.A. (Sem.III) (Main & Back) Examination, December-2010
M-306 : Finance for Strategic Decisions (Minor)

Time : 3 Hours

Total Marks : 70
Min. Passing Marks: 28

The question paper is divided in two sections. There are sections A and B. Section A contains 6 questions out of which the candidate is required to attempt any 4 questions. Section B contains short case study/application base 1 question which is compulsory.
All questions are carrying equal marks.

Use of following supporting material is permitted during examination.
(Mentioned in form No. 205)

1. ________Nil________ 2.______Nil___

SECTION-A

1. Discuss the impact of globalization on the financial decision making of corporate enterprises.

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2. "Strategic financial management in India has changed substantially in scope and complexity in view of recent government policy". Critically examine the statement.

3. (a) Discuss in brief the various money market instrument and its influence on corporate financing.

   (b) Distinguish between 'Securities Market' and 'Money Market'

4. IPCL Ltd. Wishes to acquire HPCL Ltd. On the basis of an exchange ratio of 0.8. The relevant financial data are as follows:

Particulars	IPCL Limited	HPCL Limited
Equity share outstanding	50,000	20,000
EAT (Rs.)	1,00,000	20,000
EPS (Rs.)	2	1
MPS (Rs.)	20	8

   (i) Determine the number of shares to be issued by IPCL Limited for the acquisition of HPCL Ltd.
   (ii) What is the current price earnings ratio of the two companies?
   (iii) What is the swap ratio based on current market prices?
   (iv) What is the EPS of IPCL Ltd. After acquisition?
   (v) Calculate the gain/loss for shareholders of the two companies after acquisition (a) at 0.8 exchange ratio, and (b) an exchange ratio based on market price.

5. What is securitization? What are the benefits of securitization? Explain its significance in Indian Financial System.

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6. (a) What do you mean by valuation of shares and business? How do you Determine the value of shares under net assets valuation method?

   (b) From the following particulars, calculate the fair value of an equity share assuming that out of the total assets, those amounting to Rs. 41,00,000 are fictitious:

   Share Capital

   5,50,000 10% Preference shares of Rs. 100 each, full paid up. 55,00,000 Equity shares of Rs. 10 each, fully paid up.

   Liability to outsiders Rs. 75,00,000

   Reserve and Surplus Rs. 45,00,000

   The average normal profit after taxation earned every year by the Company during the last five years Rs. 85,05,000

   The normal profit earned on the market value of fully paid equity shares of similar companies is 12%

SECTION-B

7. Under an advance factoring arrangement Bharat Factors Ltd. (BFL) has advanced sum of Rs. 14 Lakhs against the receivables purchased from ABC Ltd. The factoring agreement provides for an advance payment of 80% (maintaining 'factor reserve' of 20% to provide for disputes and deductions relating to bills assigned), of the value of factored receivable and for guaranteed payment after 3 months from the date of purchase of receivables.

   The advance carries a rate of interest of 20% per annum compounded quarterly and the factoring commission is 1.5% of the value of factored receivables. Both the interest and commission are collected upfront.

   (a) Compute the amount of advance payable to ABC Ltd.

   (b) Calculate per annum the effective cost of funds made available to ABC Limited.

M.B.A. SEM. III (Main/Back)

Examination, December-2010

(3M6330)

FINANCE FOR STRATEGIC DECISIONS

Year-2010

Time : 3 Hours

Max. Marks.:70
Min. Passing Marks :28

Instruction to candidates:

1. The question paper is divided into two sections.
2. Section A, contains 6 questions out of which the candidates is required to attempt any four questions. Section B contains short case study/application based one question which is compulsory.
3. All questions carry **equal** marks.

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Section-A

1. Discuss the impact of globalization on the financial decision making of corporate enterprises.

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EPS (Rs.)	2	1
MPS (Rs.)	20	8

(i) Determine the number of shares to be issued by IPCL Limited for the acquisition of HPCL Ltd.

(ii) What is the current price earning ratio of the two companies?

(iii) What is the swap ratio based on current market prices?

(iv) What is the EPS of IPCL Ltd. after acquisition?

(v) Calculate the gain/loss for shareholders of the two companies after acquisition (a) at 0.8 exchange ratio, and (b) an exchange ratio based on market price.

5. What is securitization ? What are the benefits of securitization? Explain its significance in Indian Financial System.

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6. (a) What do you mean by valuation of shares and business? How do you determine the value of shares under net assets valuation method?
   (b) From the following particulars, calculate the fair value of an equity share assuming that out of the total assets, those amounting to Rs.41,00,000 are fictitious :

   Share Capital:

   5,50,000 10% preference shares of Rs. 100 each, full paid up. 55,00,000 Equity shares of Rs. 10 each, fully paid up.

   Liability to outsiders Rs. 75,00,000

   Reserves and Surplus Rs. 45,00,000

   The average normal profit after taxation earned every year by the company during the last five year Rs 85,05,000 the normal profit earned on the market value of fully paid equity shares of similar companies is 12%.

Section-B

7. Under an advance factoring arrangement Bharat Factor Ltd. (BFL) has advanced sum of Rs. 14 lakhs against the receivables purchased from ABC Ltd. the factoring agreement provides for an advance payment of 80% (maintaining 'factor reserve of 20% to provide for disputes and deductions relating to bills assigned) of the value of factored receivables and for guaranteed payment after 3 months from the date of purchase of receivables.

The advance carries a rate of interest of 20% per annum compounded quarterly and the factoring commission is 1.5% of the value of factored receivable. Both the interest and commission are collected upfront.

(a) Compute the amount of advance payable to ABC Ltd.
(b) Calculate per annum the effective cost of funds made available to ABC Limited.

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Roll No. : ______________________

3M6306

M.B.A. (Sem.III) (Main & Back) Examination, December-2009
M-306 : Finance for Strategic Decisions (Major)

Time : 3 Hours **{Total Marks : 70 }**
{Min Passing Marks : 28 }

The question Paper is divided in two Sections.
Section A contains 6 questions out of which the candidate is required to attempt any 4 questions. Section B contains short case study /application based one question which is compulsory. All question are carrying equal marks.

Use of following supporting material is permitted during examination .
(Mentioned in form No. 205)

1-----------------NIL------------------- 2.---------------NIL-------------

Section-A

1- "Finance for strategic decisions combine the knowledge of financial management, strategic management ,economic and business environment to forecast and manage the future of enterprise." Explain.

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2- Discuss the role and functions of financial intermediaries in India.

3- Give an overview of Indian Financial system.

4- No method or valuation of shares by itself is perfect .A combination of different method will give a proper valuation of shares .Discuss.

5- Write short notes on :
(a)REPO
(b) TB
(c)MVA

6- Discuss the impact of world recession on Indian financial sectors and economy What are the steps taken by government to overcome it ?

Section –B

1 The Alpha Manufactures Ltd.(AML) enters in to a factoring arrangement with the Alpha Factors Ltd. According to the agreement ,the AFL would pay in advance 80% of the value of the factored receivable at 25% interest compounded quarterly, the balance retained as factor reserve to disputes and deductions. It also provides for guaranteed payment after 3 month from the date of purchase of the receivables. The factoring commission would be 2% of the value of factored receivables. It is stipulated that interest and commission would be collected in advance .Assuming on advance payment of Rs.42 lakh, Compute :

(a) Advance payble to AML
(b) Effective cost of funds ,and
(c) Effective cost of funds on the assumption that interest is collected in arrear while the commission is collected in advance.

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Roll No. ______________

Total No. of Questions : 7] [Total No. of Pages : 2

[2129]

M.B.A. IIIrd Semester (Main/Back) Examination - 2009

Finance

Finance for Strategic Decisions (Elective Major)

3M6306

Time : 3 Hours **Maximum Marks : 70**

Min. Passing Marks : 28

Instructions to Candidates:

1. *The question paper is divided in **two** sections.*
2. *There are sections A & B. Section A contains **6** questions out of which the candidate is required to attempt any 4 questions. Section B contains short case study/application based 1 question which is **compulsory.***
3. *All questions are carrying **equal** marks.*

Section - A

1. Explain the impact of financial crisis over Indian financial system? **(14)**

2. Explain the steps to be taken by government interventions to develop financial system and markets more efficient and stable? **(14)**

3. What is derivative? Explain the importance of derivatives in details? **(4+10)**

4. Explain the characteristics of various investment alternatives in reference of liquidity, maturity, yield and risk factor? **(3½+3½+3½+3½)**

5. Explain the merger & Acquisition (M & A) activity in recent years by Indian MNC's? **(14)**

3M6306 / 3100 (1) [Contd....

(37)

6. How should a firm react if it's domestic market is under attack by a foreign firm that used high profit margins at home to sell at low margins abroad? **(14)**

Section - B

7. How are the following valuation parameters related to each other? How do they affect the cash flow valuation model? **(14)**

i) Sales

ii) Investment

iii) Net Operating Income

iv) Growth Rate

v) Profitability Rate

Roll No. ________________

Total No. of Questions : 7] [Total No. of Pages : 2

[2129]

M.B.A. IIIrd Semester (Main/Back) Examination - 2009
Finance
Finance For Strategic Decisions (Minor Elective)
3M6330

Time : 3 Hours **Maximum Marks : 70**

Min. Passing Marks : 28

Instructions to Candidates:

1. *The question paper is divided in two sections.*
2. *There are sections A & B. Section A contains **6 questions** out of which the candidate is required to attempt any 4 questions. Section B contains short case study/application based 1 question which is compulsory.*
3. *All questions are carrying equal marks.*

Section - A

1. "Money is the pivot around which the economic science clusters".

   Discuss the above.

2. What is a non-banking financial company [NBFC]? Discuss the role and functions of financial intermediaries in India.

3. "Finance for strategic decisions combine the knowledge of financial management, strategic management, economic and business environment to forecast and manage the future of enterprise". Explain.

4. What is financial restructuring. Define and state the reasons for merger, takeover and amalgamation.

5. What is factoring? Explain its types and benefits.

6. Short notes :- [Any four]

   i) Exchange Rate Mechanism

   ii) Capital Markets

   iii) Forfeiting

   iv) Financial Instruments

   v) Market value added.

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Section - B

7. The Balance sheet of Avon Synthetics Ltd. as at 31st March, 2008 is given below:

Liabilities	Rs.	Assets	Rs.
Equity Share Capital		Land	14,00,000
(5,00,000 shares of		Buildings	23,00,000
Rs. 10 each)	50,00,000	Plant and Machinery	28,00,000
General Reserve	15,00,000	Sundry Debtors	6,00,000
Debentures (14%)	10,00,000	Inventory	8,00,000
Sundry Creditors	5,00,000	Cash and Bank	2,00,000
Bank Overdraft	4,00,000	Patents and trade marks	3,00,000
Provision for taxation	1,00,000	Preliminary expenses	1,00,000
	85,00,000		85,00,000

The profits of the company for the past four years are as follows : (Rs.)

2002	2003	2004	2005
12,00,000	15,00,000	21,00,000	23,00,000

Every year, the company transfers 20% of its profits to the general reserve. The industry average rate on return is 18% of the share value. On 31st March, 2008, Independent expert valuer has assessed the following assets : (Rs.)

	Rs.
Land	26,00,000
Buildings	40,00,000
Plant and Machinery	32,00,000
Debtors (after bad debts)	5,00,000
Patents and Trade marks	2,00,000

Based, on the information given above, calculate the fair value of company's share.

Bibliography

S. No.	Name of The Book	Name of The Author
1.	Financial Market and services	Gordon & Natrajan
2.	Banking Services Operations	Prianka Singh & S.K. Vishwakarma
3.	Financial Management	R.P. Rastogi
4.	Finance for Strategic Decision	Sonal Jain, Rathi & Malhar
5.	Marketing of Financial Services	Jain, Rathi, Thakur & Solanki
6.	Strategic Financial Management	Ravi M. Kishore & J. B. Gupta
7.	Financial Markets & Services	Vasant Desai

Website:

www.sebi.govt.in