

## PAPER – 2 : STRATEGIC FINANCIAL MANAGEMENT

*Question No.1 is compulsory.*

*Attempt any **five** questions from the remaining **six** questions*

*Working notes should form part of the answer*

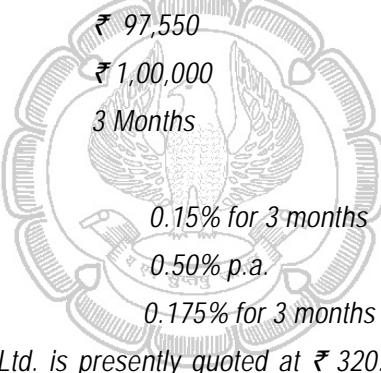
### Question 1

- (a) Amal Ltd. has been maintaining a growth rate of 12% in dividends. The company has paid dividend @ ₹ 3 per share. The rate of return on market portfolio is 15% and the risk-free rate of return in the market has been observed as 10%. The beta co-efficient of the company's share is 1.2.

You are required to calculate the expected rate of return on the company's shares as per CAPM model and the equilibrium price per share by dividend growth model. (5 Marks)

- (b) From the following particulars, calculate the effective rate of interest p.a. as well as the total cost of funds to Bhaskar Ltd., which is planning a CP issue:

Issue Price of CP



Face Value

Maturity Period

Issue Expenses:

Brokerage

Rating Charges

Stamp Duty

(5 Marks)

- (c) Equity share of PQR Ltd. is presently quoted at ₹ 320. The Market Price of the share after 6 months has the following probability distribution:

Market Price	₹ 180	260	280	320	400
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Probability	0.1	0.2	0.5	0.1	0.1
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A put option with a strike price of ₹ 300 can be written.

You are required to find out expected value of option at maturity (i.e. 6 months) (5 Marks)

- (d) Calculate Market Price of:

(i) 10% Government of India security currently quoted at ₹ 110, but interest rate is expected to go up by 1%.

(ii) A bond with 7.5% coupon interest, Face Value ₹ 10,000 & term to maturity of 2 years, presently yielding 6%. Interest payable half yearly. (5 Marks)

### Answer

- (a) Capital Asset Pricing Model (CAPM) formula for calculation of expected rate of return is

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$$E_R = R_f + \beta (R_m - R_f)$$

$E_R$  = Expected Return

$\beta$  = Beta of Security

$R_m$  = Market Return

$R_f$  = Risk free Rate

$$= 10 + [1.2 (15 - 10)]$$

$$= 10 + 1.2 (5)$$

$$= 10 + 6 = 16\% \text{ or } 0.16$$

Applying dividend growth mode for the calculation of per share equilibrium price:-

$$E_R = \frac{D_1}{P_0} + g$$

$$\text{or } 0.16 = \frac{3(1.12)}{P_0} + 0.12$$

$$\text{or } 0.16 - 0.12 = \frac{3.36}{P_0}$$

$$\text{or } 0.04 P_0 = 3.36$$

$$\text{or } P_0 = \frac{3.36}{0.04} = \text{Rs. } 84$$

Therefore, equilibrium price per share will be Rs. 84.

$$(b) \text{ Effective Interest} = \frac{\frac{F - P}{P} \times \frac{12}{M}}{100}$$

Where

F= Face Vale

P= Issue Price

$$= \frac{1,00,000 - 97,550}{97,550} \times \frac{12}{3} \times 100$$

$$= 0.025115 \times 4 \times 100$$

$$= 10.046 = 10.05\% \text{ p.a.}$$

\ Effective interest rate = 10.05% p.a.

**Cost of Funds to the Company**

Effective Interest	10.05%
Brokerage (0.150 × 4)	0.60%
Rating Charge	0.50%
Stamp duty (0.175 × 4)	0.70%
	<b>11.85%</b>

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**(c) Expected Value of Option**

$(300 - 180) \times 0.1$	12
$(300 - 260) \times 0.2$	8
$(300 - 280) \times 0.5$	10
$(300 - 320) \times 0.1$	Not Exercised*
$(300 - 400) \times 0.1$	<u>Not Exercised*</u>
	<u>30</u>

\* If the strike price goes beyond Rs. 300, option is not exercised at all.

In case of Put option, since Share price is greater than strike price Option Value would be zero.

**(d) (i) Current yield = (Coupon Interest / Market Price) X 100**

$$(10/110) \times 100 = 9.09\%$$

If current yield go up by 1% i.e. 10.09 the market price would be

$$10.09 = 10 / \text{Market Price} \times 100$$

$$\text{Market Price} = \text{Rs. } 99.11$$

$$\begin{aligned} \text{(ii) Market Price of Bond} &= \text{P.V. of Interest} + \text{P.V. of Principal} \\ &= \text{Rs. } 1,394 + \text{Rs. } 8,885 \\ &= \text{Rs. } 10,279 \end{aligned}$$

**Question 2**

**(a)** Derivative Bank entered into a plain vanilla swap through on OIS (Overnight Index Swap) on a principal of ₹ 10 crores and agreed to receive MIBOR overnight floating rate for a fixed payment on the principal. The swap was entered into on Monday, 2<sup>nd</sup> August, 2010 and was to commence on 3<sup>rd</sup> August, 2010 and run for a period of 7 days.

Respective MIBOR rates for Tuesday to Monday were:

7.75%, 8.15%, 8.12%, 7.95%, 7.98%, 8.15%.

If Derivative Bank received ₹ 317 net on settlement, calculate Fixed rate and interest under both legs.

**Notes:**

- (i) Sunday is Holiday.
- (ii) Work in rounded rupees and avoid decimal working. (8 Marks)

**(b)** MK Ltd. is considering acquiring NN Ltd. The following information is available:

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<i>Company</i>	<i>Earning after tax(₹)</i>	<i>No. of Equity Shares</i>	<i>Market Value Per Share(₹)</i>
MK Ltd.	60,00,000	12,00,000	200.00
NN Ltd.	18,00,000	3,00,000	160.00

*Exchange of equity shares for acquisition is based on current market value as above. There is no synergy advantage available.*

- (i) Find the earning per share for company MK Ltd. after merger, and
- (ii) Find the exchange ratio so that shareholders of NN Ltd. would not be at a loss.

(8 Marks)

**Answer**

(a)

Day	Principal (Rs.)	MIBOR (%)	Interest (Rs.)
Tuesday	10,00,00,000	7.75	21,233
Wednesday	10,00,21,233	8.15	22,334
Thursday	10,00,43,567	8.12	22,256
Friday	10,00,65,823	7.95	21,795
Saturday & Sunday (*)	10,00,87,618	7.98	43,764
Monday	10,01,31,382	8.15	<u>22,358</u>
Total Interest @ Floating			1,53,740
Less: Net Received			<u>317</u>
Expected Interest @ fixed			1,53,423
Thus Fixed Rate of Interest			0.07999914%
Approx.			8%

(\*) i.e. interest for two days.

Note: Alternatively, answer can also be calculated on the basis of 360days in a year.

- (b) (i) Earning per share of company MK Ltd after merger:-

Exchange ratio  $160 : 200 = 4 : 5$ .

that is 4 shares of MK Ltd. for every 5 shares of NN Ltd.

\ Total number of shares to be issued =  $4/5 \times 3,00,000 = 2,40,000$  Shares.

\ Total number of shares of MK Ltd. and NN Ltd.= $12,00,000$  (MK Ltd.)+ $2,40,000$  (NN Ltd.)

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	= 14,40,000 Shares
Total profit after tax	= Rs. 60,00,000 MK Ltd.
	= <u>Rs. 18,00,000</u> NN Ltd.
	= Rs. 78,00,000

\ EPS. (Earning Per Share) of MK Ltd. after merger

$$\text{Rs. } 78,00,000 / 14,40,000 = \text{Rs. } 5.42 \text{ per share}$$

(ii) To find the exchange ratio so that shareholders of NN Ltd. would not be at a Loss:

Present earning per share for company MK Ltd.

$$= \text{Rs. } 60,00,000 / 12,00,000 = \text{Rs. } 5.00$$

Present earning per share for company NN Ltd.

$$= \text{Rs. } 18,00,000 / 3,00,000 = \text{Rs. } 6.00$$

\ Exchange ratio should be 6 shares of MK Ltd. for every 5 shares of NN Ltd.

\ Shares to be issued to NN Ltd. =  $3,00,000 \times 6/5 = 3,60,000$  shares

Now, total No. of shares of MK Ltd. and NN Ltd. =  $12,00,000 (\text{MK Ltd.}) + 3,60,000 (\text{NN Ltd.})$

$$= 15,60,000 \text{ shares}$$

\ EPS after merger =  $\text{Rs. } 78,00,000 / 15,60,000 = \text{Rs. } 5.00 \text{ per share}$

Total earnings available to shareholders of NN Ltd. after merger = 3,60,000 shares

$$\times \text{Rs. } 5.00 = \text{Rs. } 18,00,000.$$

This is equal to earnings prior merger for NN Ltd.

\ Exchange ratio on the basis of earnings per share is recommended.

**Question 3**

(a) Delta Ltd.'s current financial year's income statement reports its net income as ₹ 15,00,000. Delta's marginal tax rate is 40% and its interest expense for the year was ₹ 15,00,000. The company has ₹ 1,00,00,000 of invested capital, of which 60% is debt. In addition, Delta Ltd. tries to maintain a Weighted Average Cost of Capital (WACC) of 12.6%.

- (i) Compute the operating income or EBIT earned by Delta Ltd. in the current year.
- (ii) What is Delta Ltd.'s Economic Value Added (EVA) for the current year?
- (iii) Delta Ltd. has 2,50,000 equity shares outstanding. According to the EVA you computed in (ii), how much can Delta pay in dividend per share before the value of the company would start to decrease? If Delta does not pay any dividends, what would you expect to happen to the value of the company? (8 Marks)

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- (b) A Dealer quotes "All-in-Cost" for a generic swap at 8% against six months LIBOR flat. If the notional principal amount of swap is ₹ 6,00,000,-
- Calculate semi-annual fixed payment.
  - Find the first floating rate payment for (i) above, if the six-month period from the effective date of swap to the settlement date comprises 181 days and that the corresponding LIBOR was 6% on the effective date of swap.
  - In (ii) above, if the settlement is on 'NET' basis, how much the fixed rate payer would pay to the floating rate payer ? Generic swap is based on 30/360 days.

(8 Marks)

### Answer

- (a) (i) Taxable income = Net Income / (1 - 0.40)  
 or, Taxable income = Rs. 15,00,000 / (1 - 0.40) = Rs. 25,00,000  
 Again, taxable income = EBIT - Interest  
 or, EBIT = Taxable Income + Interest  
 = Rs. 25,00,000 + Rs. 15,00,000 = Rs. 40,00,000  
 (ii) EVA = EBIT (1 - T) - (WACC \* Invested capital)  
 = Rs. 40,00,000 (1 - 0.40) - (0.126 \* Rs. 1,00,00,000)  
 = Rs. 24,00,000 - Rs. 12,60,000 = Rs. 11,40,000  
 (iii) EVA Dividend = Rs. 11,40,000 / 2,50,000 = Rs. 4.56

If Delta Ltd. does not pay a dividend, we would expect the value of the firm to increase because it will achieve higher growth, hence a higher level of EBIT. If EBIT is higher, then all else equal, the value of the firm will increase.

- (b) (i) Semi-Annual fixed payment = (N) (AIC) (Period)  
 Where, N = Notional Principal Amount = Rs. 6,00,000  
 All-In-Cost (AIC) = 8% = 0.08  
 = Rs. 6,00,000 \* 0.08 \* 180/360  
 = Rs. 6,00,000 \* 0.08 \* 0.5  
 = Rs. 6,00,000 \* 0.04 = Rs. 24,000  
 (ii) Floating rate payment = N(LIBOR) (dt/360)  
 = Rs. 6,00,000 \* 0.06 \* 181/360  
 = Rs. 6,00,000 \* 0.06 \* (0.502777)  
 = Rs. 18,100

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$$\begin{aligned}
 \text{(iii) Net Amount} &= \text{(i)} - \text{(ii)} \\
 \text{or} &= \text{Rs. } 24,000 - \text{Rs. } 18,100 = \text{Rs. } 5,900.
 \end{aligned}$$

**Question 4**

- (a) A valuation done of an established company by a well-known analyst has estimated a value of ₹ 500 lakhs, based on the expected free cash flow for next year of ₹ 20 lakhs and an expected growth rate of 5%.

While going through the valuation procedure, you found that the analyst has made the mistake of using the book values of debt and equity in his calculation. While you do not know the book value weights he used, you have been provided with the following information:

- (i) Company has a cost of equity of 12%,
- (ii) After tax cost of debt is 6%,
- (iii) The market value of equity is three times the book value of equity, while the market value of debt is equal to the book value of debt.

You are required to estimate the correct value of the company. (8 Marks)

- (b) Rahul Ltd. has surplus cash of ₹ 100 lakhs and wants to distribute 27% of it to the shareholders. The company decides to buyback shares. The Finance Manager of the company estimates that its share price after re-purchase is likely to be 10% above the buyback price-if the buyback route is taken. The number of shares outstanding at present is 10 lakhs and the current EPS is ₹ 3.

You are required to determine:

- (i) The price at which the shares can be re-purchased, if the market capitalization of the company should be ₹ 210 lakhs after buyback,
- (ii) The number of shares that can be re-purchased, and
- (iii) The impact of share re-purchase on the EPS, assuming that net income is the same. (8 Marks)

**Answer**

- (a) Cost of capital by applying Free Cash Flow to Firm (FCFF) Model is as follows:-

$$\text{Value of Firm} = V_0 = \frac{\text{FCFF}_1}{K_c - g_n}$$

Where –

$\text{FCFF}_1$  = Expected FCFF in the year 1

$K_c$  = Cost of capital

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$g_n$  = Growth rate forever

Thus, Rs. 500 lakhs = Rs. 20 lakhs  $/(K_c - g)$

Since  $g = 5\%$ , then  $K_c = 9\%$

Now, let  $X$  be the weight of debt and given cost of equity = 12% and cost of debt = 6%,  
then  $12\% (1 - X) + 6\% X = 9\%$

Hence,  $X = 0.50$ , so book value weight for debt was 50%

\ Correct weight should be 75% of equity and 25% of debt.

\ Cost of capital =  $K_c = 12\% (0.75) + 6\% (0.25) = 10.50\%$

and correct firm's value =  $Rs. 20 \text{ lakhs} / (0.105 - 0.05) = Rs. 363.64 \text{ lakhs.}$

- (b) (i) Let  $P$  be the buyback price decided by Rahul Ltd.

Market Capitalisation after Buyback

$1.1P (\text{Original Shares} - \text{Shares Bought Back})$

$$= 1.1P \times 10 \text{ lakhs} - \frac{27\% \text{ of } 100 \text{ lakhs}}{P} \times 10 \text{ lakhs}$$

$$= 11 \text{ lakhs} - P - 2.7 \text{ lakhs} \times 1.1$$

$$= 11 \text{ lakhs} P - 29.7 \text{ lakhs}$$

Again,  $11 \text{ lakhs} P - 29.7 \text{ lakhs}$

or  $11 \text{ lakhs} P = 210 \text{ lakhs} + 29.7 \text{ lakhs}$

$$\text{or } P = \frac{239.7}{11} = \text{Rs. } 21.79 \text{ per share}$$

- (ii) Number of Shares to be Bought Back :-

$$\frac{\text{Rs. } 27 \text{ lakhs}}{\text{Rs. } 21.79} = 1.24 \text{ lakhs (Approx.) or } 123910 \text{ shares}$$

- (iii) New Equity Shares :-

$10 \text{ lakhs} - 1.24 \text{ lakhs} = 8.76 \text{ lakhs}$  or  $1000000 - 123910 = 876090 \text{ shares}$

$$\text{or EPS} = \frac{3 \times 10 \text{ lakhs}}{8.76 \text{ lakhs}} = \text{Rs. } 3.43$$

Thus, EPS of Rahul Ltd., increases to Rs. 3.43.

### Question 5

- (a) Consider the following information on two stocks X and Y:

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<i>Year</i>	<i>Return on X (%)</i>	<i>Return on Y (%)</i>
2008	12	10
2009	18	16

*You are required to determine:*

- (i) *The expected return on a portfolio containing X and Y in the proportion of 60% and 40% respectively.*
- (ii) *The standard deviation of return from each of the two stocks.*
- (iii) *The covariance of returns from the two stocks.*
- (iv) *Correlation co-efficient between the returns of the two stocks.*
- (v) *The risk of portfolio containing X and Y in the proportion of 60% and 40%.*

(8 Marks)

- (b) *Shashi Co. Ltd has projected the following cash flows from a project under evaluation:*

<i>Year</i>	<i>0</i>	<i>1</i>	<i>2</i>	<i>3</i>
₹ (in lakhs)	(72)	30	40	30

*The above cash flows have been made at expected prices after recognizing inflation. The firm's cost of capital is 10%. The expected annual rate of inflation is 5%. Show how the viability of the project is to be evaluated. PVF at 10% for 1-3 years are 0.909, 0.826 and 0.751.*

(8 Marks)

**Answer**

- (a) (i) *Expected return of the portfolio X and Y*

$$E(X) = (12 + 18)/2 = 15\%$$

$$E(Y) = (10 + 16)/2 = 13\%$$

$$R_p = 0.6(15) + 0.4(13) = 14.2\%$$

- (ii) *Stock X*

$$\text{Variance} = \frac{\sum_{t=1}^n (X_t - \bar{X})^2}{N}$$

$$\text{Variance} = 0.5(12 - 15)^2 + 0.5(18 - 15)^2 = 9$$

$$\text{Standard deviation} = \sqrt{9} = 3\%$$

*Stock Y*

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$$\text{Variance} = \frac{\sum_{t=1}^n (Y_t - \bar{Y})^2}{N}$$

$$\text{Variance} = 0.5(10 - 13)^2 + 0.5(16 - 13)^2 = 9$$

$$\text{Standard deviation} = \sqrt{9} = 3\%$$

(iii) Covariance of Stocks X and Y

$$\text{Covariance} = \frac{\sum_{t=1}^n (X_t - \bar{X})(Y_t - \bar{Y})}{N}$$

$$\text{Cov}_{XY} = 0.5(12 - 15)(10 - 13) + 0.5(18 - 15)(16 - 13) = 9$$

(iv) Correlation of Coefficient

$$g_{XY} = \frac{\text{COV}_{XY}}{s_X s_Y} = \frac{9}{3 \cdot 3} = 1$$

(v) Portfolio Risk

$$\begin{aligned} s_P &= \sqrt{(0.6)^2 (3)^2 + (0.4)^2 (3)^2 + 2(0.6)(0.4)(3)(3)(1)} \\ &= \sqrt{3.24 + 1.44 + 4.32} \\ &= \sqrt{9} = 3\% \end{aligned}$$

- (b) Here the given cash flows have to be adjusted for inflation. Alternatively, the discount rate can be converted into nominal rate, as follows:-

$$\text{Year 1} = \frac{0.909}{1.05} = 0.866; \text{ Year 2} = \frac{0.826}{(1.05)^2} \text{ or } \frac{0.826}{1.1025} = 0.749$$

$$\text{Year 3} = \frac{0.751}{(1.05)^3} = \frac{0.751}{1.1576} = 0.649$$

Year	Nominal Cash Flows (Rs. in lakhs)	Adjusted PVF as above	PV of Cash Flows (Rs. in lakhs)
1	30	0.866	25.98
2	40	0.749	29.96
3	30	0.649	19.47
Cash Inflow			75.41
Less: Cash Outflow			72.00
Net Present Value			3.41

With positive NPV, the project is financially viable.

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**Alternative Solution**

Assumption: The cost of capital given in the question is "Real".

$$\text{Nominal cost of capital} = (1.10)(1.05) - 1 = 0.155 = 15.50\%$$

DCF Analysis of the project

(Rs. Lakhs)

	Period	PVF @15.50%	CF	PV
Investment	0	1	-72	-72.00
Operation	1	0.866	30	+25.98
---do---	2	0.750	40	+30.00
---do---	3	0.649	30	+19.47
NPV				+3.45

The proposal may be accepted as the NPV is positive.

**Question 6**

- (a) Given the following information:

Exchange rate-Canadian Dollar 0.666 per DM (Spot)

Canadian Dollar 0.671 per DM (3 months)

Interest rates-DM 8% p.a.

Canadian Dollar 10% p.a.

What operations would be carried out to earn the possible arbitrage gains? (8 Marks)

- (b) The following information relates to Maya Ltd:

Earnings of the company ₹ 10,00,000

Dividend payout ratio 60%

No. of Shares outstanding 2,00,000

Rate of return on investment 15%

Equity capitalization rate 12%

- (i) What would be the market value per share as per Walter's model?

- (ii) What is the optimum dividend payout ratio according to Walter's model and the market value of company's share at that payout ratio? (8 Marks)

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### Answer

- (a) In this case, DM is at a premium against the Canadian \$ premium = [(0.671 – 0.666) /0.666] x 12/3 x 100 = 3.00 %.

Whereas interest rate differential = 10% – 8% = 2%

Since the interest rate differential is smaller than the premium, it will be profitable to place money in Deutsch Marks the currency whose 3 months interest is lower.

The following operations are carried out:-

- (i) Borrow CAN \$ 1000 at 10% for 3 months,
- (ii) Change this sum into DM at the Spot Rate to obtain DM = (CAN \$1000/0.666) = 1501.50
- (iii) Place DM 1501.50 in the money market for 3 months to obtain a sum of DM-

A sum of DM –

Principal	DM 1501.50
Add: interest @ 8% for 3 months	<u>DM 30.03</u>
	<u>DM 1531.53</u>

- (iv) Sell DM at 3 months forward to obtain DM 1531.53 x 0.671 = CAN \$ 1027.66

- (v) Refund the debt taken in CAN \$ with the interest due on it, i.e.

Principal –	CAN \$ 1000.00
Add: interest @ 10% for 3 months	<u>CAN \$ 25.00</u>
Total	<u>CAN \$ 1025.00</u>

\ Net arbitrage gain = CAN \$ 1027.66 – CAN \$ 1025.00 = CAN \$ 2.66.

- (b) MAYA Ltd.

- (i) Walter's model is given by –

$$p = \frac{D + (E - D)(g/k_e)}{k_e}$$

Where, p = Market price per share,

E = Earning per share – Rs. 5

D = Dividend per share – Rs 3

g = Return earned on investment – 15%

$k_e$  = Cost of equity capital – 12%

$$\backslash p = \frac{3 + (5 - 3) \cdot \frac{0.15}{0.12}}{0.12} = \frac{3 + 2 \cdot \frac{.15}{.12}}{.12} = \text{Rs. } 45.83$$

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- (ii) According to Walter's model when the return on investment is more than the cost of equity capital, the price per share increases as the dividend pay-out ratio decreases. Hence, the optimum dividend pay-out ratio in this case is Nil. So, at a payout ratio of zero, the market value of the company's share will be:-

$$\frac{0 + (5 - 0) \cdot \frac{15}{.12}}{.12} = \text{Rs. } 52.08$$

**Question 7**

*Answer any four from the following:*

- (a) (i) *What is the meaning of NBFC?* (4 Marks)  
(ii) *What are the different categories of NBFCs?* (4 Marks)  
(iii) *Explain briefly the regulation of NBFCs under RBI Act.* (4 Marks)
- (b) *Explain the concept 'Zero date of a Project' in project management.* (4 Marks)
- (c) *Give the meaning of 'Caps, Floors and Collars' options.* (4 Marks)
- (d) *Distinguish between Open-ended and Close-ended Schemes.* (4 Marks)
- (e) *Explain CAMEL model in credit rating.* (4 Marks)

**Answer**

- (a) (i) Meaning of NBFC (Non Banking Financial Companies)

NBFC stands for Non-Banking financial institutions, and these are regulated by the Reserve Bank of India under RBI Act, 1934. NBFC's principal business is receiving of deposits under any scheme or arrangement or in any other manner or lending on any other manner. They normally provide supplementary finance to the corporate sector.

- (ii) Different categories of NBFC are

1. Loan companies
2. Investment Companies.
3. Hire Purchase Finance Companies.
4. Equipment Leasing Companies.
5. Mutual Benefit Finance Companies.
6. Housing Finance Companies
7. Miscellaneous Finance Companies

- (iii) Regulation of NBFCs-RBI Act

RBI regulates the NBFC through the following measures:

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- (a) Mandatory Registration.
  - (b) Minimum owned funds.
  - (c) Only RBI authorized NBFCs can accept public deposits.
  - (d) RBI prescribes the ceiling of interest rate.
  - (e) RBI prescribes the period of deposit.
  - (f) RBI prescribes the prudential norms regarding utilization of funds.
  - (g) RBI directs their investment policies.
  - (h) RBI inspectors conduct inspections of such companies.
  - (i) RBI prescribes the points which should be examined and reported by the auditors of such companies.
  - (j) RBI prescribes the norms for preparation of Accounts particularly provisioning of possible losses.
  - (k) If any of interest or principal or both is/ are due from any customer for more than 6 months, the amount is receivable (interest or principal or both) is termed as non-performing asset.
- (b) Zero Date of a Project means a date is fixed from which implementation of the project begins. It is a starting point of incurring cost. The project completion period is counted from the zero date. Pre-project activities should be completed before zero date. The pre-project activities should be completed before zero date. The pre-project activities are:
- a. Identification of project/product
  - b. Determination of plant capacity
  - c. Selection of technical help/collaboration
  - d. Selection of site.
  - e. Selection of survey of soil/plot etc.
  - f. Manpower planning and recruiting key personnel
  - g. Cost and finance scheduling.
- (c) 'Cap Floors & Collars' options

**Cap:** It is a series of call options on interest rate covering a medium-to-long term floating rate liability. Purchase of a Cap enables the a borrowers to fix in advance a maximum borrowing rate for a specified amount and for a specified duration, while allowing him to avail benefit of a fall in rates. The buyer of Cap pays a premium to the seller of Cap.

**Floor:** It is a put option on interest rate. Purchase of a Floor enables a lender to fix in advance, a minimal rate for placing a specified amount for a specified duration, while allowing him to avail benefit of a rise in rates. The buyer of the floor pays the premium to the seller.

**Collars:** It is a combination of a Cap and Floor. The purchaser of a Collar buys a Cap and simultaneously sells a Floor. A Collar has the effect of locking its purchases into a floating rate of interest that is bounded on both high side and the low side.

## **FINAL (NEW) EXAMINATION : NOVEMBER, 2010**

### **(d) Open Ended and Close Ended Schemes**

Open Ended Scheme do not have maturity period. These schemes are available for subscription and repurchase on a continuous basis. Investor can conveniently buy and sell unit. The price is calculated and declared on daily basis. The calculated price is termed as NAV. The buying price and selling price is calculated with certain adjustment to NAV. The key feature of the scheme is liquidity.

Close Ended Scheme has a stipulated maturity period normally 5 to 10 years. The Scheme is open for subscription only during the specified period at the time of launch of the scheme. Investor can invest at the time of initial issue and thereafter they can buy or sell from stock exchange where the scheme is listed. To provide an exit route some close-ended schemes give an option of selling bank (repurchase) on the basis of NAV. The NAV is generally declared on weekly basis.

### **(e) CAMEL Model in Credit Rating**

Camel stands for Capital, Assets, Management, Earnings and Liquidity. The CAMEL model adopted by the rating agencies deserves special attention, it focuses on the following aspects-

- (i) *Capital*- Composition of external funds raised and retained earnings, fixed dividends component for preference shares and fluctuating dividends component for equity shares and adequacy of long term funds adjusted to gearing levels, ability of issuer to raise further borrowings.
- (ii) *Assets*- Revenue generating capacity of existing/proposed assets, fair values, technological/physical obsolescence, linkage of asset values to turnover, consistency, appropriateness of methods of depreciation and adequacy of charge to revenues, size, ageing and recoverability of monetary assets like receivables and its linkage with turnover.
- (iii) *Management*- Extent of involvement of management personnel, team-work, authority, timeliness, effectiveness and appropriateness of decision making along with directing management to achieve corporate goals.
- (iv) *Earnings*- Absolute levels, trends, stability, adaptability to cyclical fluctuations, ability of the entity to service existing and additional debts proposed.
- (v) *Liquidity*- Effectiveness of working capital management, corporate policies for stock and creditors, management and the ability of the corporate to meet their commitment in the short run.

These five aspects form the five core bases for estimating credit worthiness of an issuer which leads to the rating of an instrument. Rating agencies determine the pre-dominance of positive/negative aspects under each of these five categories and these are factored in for making the overall rating decision.