

Question 2). What are the key decisions falling within the scope of financial strategy?

[MTP Apr'21 , Jan'21 , Nov'19, MTP Oct'19] (4 marks)

Answer: -

The key decisions falling within the scope of financial strategy include the following:

1) Financing decisions:

These decisions deal with the mode of financing or mix of equity capital and debt capital.

2) Investment decisions:

These decisions involve the profitable utilization of firm's funds especially in long-term projects (capital projects). Since the future benefits associated with such projects are not known with certainty, investment decisions necessarily involve risk. The projects are therefore evaluated in relation to their expected return and risk.

3) Dividend decisions:

These decisions determine the division of earnings between payments to shareholders and reinvestment in the company.

4) Portfolio decisions:

These decisions involve evaluation of investments based on their contribution to the aggregate performance of the entire corporation rather than on the isolated characteristics of the investments themselves.

**Cost of Equity & Price under Dividend Discount model**

Question 11). Shares of Voyage Ltd. are being quoted at a price-earning ratio of 8 times. The company retains ₹ 5 per share which is 45% of its Earning Per Share.

You are required to compute

- (i) The cost of equity to the company if the market expects a growth rate of 15% p.a.**
- (ii) If the anticipated growth rate is 16% per annum, calculate the indicative market price with the same cost of capital.**
- (iii) If the company's cost of capital is 20% p.a. & the anticipated growth rate is 19% p.a., calculate the market price per share.**

[Nov'18] (8 Marks)

Answer: -

(i) Cost of Capital

Retained earnings (45%)	₹ 5 per share
Dividend (55%)	₹ 6.11 per share
EPS (100%)	₹ 11.11 per share
P/E Ratio	8 times
Market price	₹ 11.11 × 8 = ₹ 88.88

Cost of equity capital

$$= \left(\frac{\text{Div}}{\text{Price}} \times 100 \right) + \text{Growth \%} = \frac{\text{₹ 6.11}}{\text{₹ 88.88}} \times 100 + 15\%$$

$$= 21.87\%$$

(ii) Market Price

$$= \left(\frac{\text{Dividend}}{\text{Cost of Capital (\%)} - \text{Growth rate (\%)}} \right)$$

$$= \frac{\text{₹ 6.11}}{(21.87 - 16) (\%)}$$

$$= \text{₹ 104.08 per share}$$

(iii) Market Price = $\frac{\text{₹ 6.11}}{(20 - 19) (\%)}$

$$= \text{₹ 611.00 per share}$$

Extra Questions for Practice

Expected Rate of Return CAPM, Average return
(Similar to Question 27)

Question 1). Your client is holding the following securities:

Particulars of Securities	Cost ₹	Dividends ₹	Market Price ₹	BETA
Equity Shares:				
Co. X	8,000	800	8,200	0.8
Co. Y	10,000	800	10,500	0.7
Co. Z	16,000	800	22,000	0.5
PSU Bonds	34,000	3,400	32,300	0.2

Assuming a Risk-free rate of 15%, calculate:

- Expected rate of return in each, using the Capital Asset Pricing Model (CAPM).
- Simple Average return of the portfolio.