SUGGESTED SOLUTION

CA FINAL NOVEMBER 2016 EXAM

S.F.M.

Test Code - F N J 6 0 2 6

BRANCH - (MULTIPLE)

Head Office : Shraddha, 3rd Floor, Near Chinai College, Andheri (E), Mumbai – 69.

Tel : (022) 26836666

Answer-1 (a) :

(a) For leading the payment, the firm has to borrow Rs. 45,05,000.

	Cash outflow after 2 months
Without leading	Rs. 45,36,000
With leading	Rs. 45,05,000 (1.015) = Rs. 45,72,575

(2 Marks)

(b) For leading the payment, the firm has to borrow Rs. 44,59,950

	Cash outflow after 2 months
Without leading	Rs. 45,36,000
With leading	Rs. 44,59,950 (1.015) = Rs. 45,26,849.25

(2 Marks)

Leading is not recommended in case of (a)

Leading is recommended in case of (b) **(1 Mark)**

Answer-1 (b) :

(i) Current price of the Bond = 100 x [1-{45/360} x 0.06] = Rs. 99.25
Alternatively, the current price of bond may also be calculated as follows:

$$\frac{D}{100-D} x \frac{360}{45} = 0.06$$

$$\frac{D}{100-D} = 0.06x \frac{45}{360}$$

$$\frac{D}{100-D} = 0.06x \frac{1}{8}$$

8D = 6 – 0.06D
8.06D = 6

$$D = \frac{6}{8.06} = 0.7444$$

(2 Marks)

Current price of the bond = Face value – D
= Rs.100 – 0.7444 = Rs.99.2556

(ii) Bond equivalent yield = $\frac{100-99.25}{99.25} x \frac{360}{45} = 6.045\%P.A.$ **(1.5 Marks)**

(iii) Effective annual return = $\left[1+\left(0.06045/8\right)^{8}\right] = 1 = 6.207\%P.A.$ **(1.5 Marks)**

Note: If a year of 365 days is considered the Bond equivalent yield and Effective annual return works out to 6.296% P.A.

Answer-1 (c) :

Workings:

Asset turnover ratio	= 1.1
Total Assets	= Rs.600
Turnover Rs. 600 lakhs × 11	= Rs. 660 lakhs
Effective interest rate	= $\frac{\text{Interest}}{\text{Liabilities}}$ = 8%
Liabilities	= Rs.125 lakhs + 50 lakhs = 175 lakh
Interest	= Rs. 175 lakhs × 0.08 = Rs. 14 lakh
Operating Margin	= 10%
Hence operating cost	= (1 - 0.10) Rs. 660 lakhs = Rs. 594 lakh
Dividend Payout	= 16.67%
Tax rate	= 40%

(i) Income statement

	(Rs. Lakhs)
Sale	660
Operating Exp	594
EBIT	66
Interest	14
EBT	52
Tax @ 40%	20.80
EAT	31.20
Dividend @ 16.67%	5.20
Retained Earnings	26.00

(ii) SGR = G = ROE (1-b)

ROE = $\frac{PAT}{NW}$ and NW = Rs.100 lakh + Rs.300 lakh = 400 lakh

ROE = $\frac{\text{Rs.}31.2 \text{ lakh}}{Rs.400 \text{ lakhs}}$ x 100 = 7.8%

SGR = 0.078(1 - 0.1667) = 6.5%

(iii) Calculation of fair price of share using dividend discount model

$$P_0 = \frac{D_o(1+g)}{K_e - g} \text{ R}$$

Dividends = $\frac{\text{Rs.}5.2 \text{ lakhs}}{\text{Rs.}10 \text{ lakhs}}$ = Rs.0.52

Growth Rate = 6.5%

Hence $P_0 = \frac{\text{Rs.}0.52\ (1+0.065)}{0.15-0.065} = \frac{\text{Rs.}0.5538}{0.085} = \text{Rs.}6.51$

(iv) Since the current market price of share is Rs.14, the share is overvalued. Hence the investor should not invest in the company.

Answer-2 (a) :

The following table demonstrates the potential impact of the three possible schemes, on each set of shareholders.

Number of Simpson Ltd.'s shares issued to shareholders of Wilson Ltd.	Exchange ratio [(1)/10,000 shares of Wilson Ltd.]	Number of Simpson Ltd.'s shares outstanding after merger [50,000 + (1)]	Fraction of Simpson Ltd. (Post merger) owned by Wilson Ltd.'s shareholders [(1)/(3)]	Value of shares owned by Wilson Ltd.'s shareholders [(4) x 35,00,000]	Fraction of Simpson Ltd. (combined Post-merger owned by Simpson Ltd.'s shareholders [50,000 / (3)]	Value of shares owned by Simpson Ltd.'s shareholders [(6) x 35,00,000]
(1)	(2)	(3)	(4)	(5)	(6)	(7)
20,000	2	70,000	2/7	10,00,000	5/7	25,00,000
25,000	2.5	75,000	1/3	11,66,667	2/3	23,33,333
30,000	3	80,000	3/8	13,12,500	5/8	21,87,500

Thus from above it is clear that except case of exchange ratio of 20000 shares, in remaining cases the value of shares will increase for both companies. **(8 Marks)**

Answer-2 (b) :

Calculation of expected return on market portfolio (R_m)

Investment	Cost (Rs.)	Dividends (Rs.)	Capital Gains (Rs.)
Shares X	8,000	800	200

Shares Y	10,000	800	500
Shares Z	16,000	800	6,000
PSU Bonds	34,000	3,400	–1,700
	68,000	**5,800**	**5,000**

(3 Marks)

$$R_m = \frac{5,800 + 5,000}{68,000} \text{ x } 100 = 15.88\%$$ **(1 Mark)**

Calculation of expected rate of return on individual security:

Security		
Shares X	15 + 0.8 (15.88 – 15.0)	= 15.70%
Shares Y	15 + 0.7 (15.88 – 15.0)	= 15.62%
Shares Z	15 + 0.5 (15.88 – 15.0)	= 15.44%
PSU Bonds	15 + 0.2 (15.88 – 15.0)	= 15.18%

(3 Marks)

Calculation of the Average Return of the Portfolio:

$$= \frac{15.70 + 15.62 + 15.44 + 15.18}{4} = 15.49\%$$ **(1 Mark)**

Answer-3 (a) :

Yield for 9 months (120% x 9/12) = 90% **(1 Mark)**

Market value of Investments as on 31.03.2011 = Rs. 50,000/- + (Rs. 50,000x 90%)
= Rs.95,000/

Therefore, NAV as on 31.03.2011 = (Rs. 95,000 - Rs. 5,000)/5,000 = Rs.18.00 **(2 Marks)**

Since dividend was reinvested by Mr. X, additional units acquired = $\frac{\text{Rs.}5,000}{\text{Rs.}18} = 277.78 \text{ unit}$

Therefore, units as on 31.03.2011 = 5,000 + 277.78 = 5,277.78

Alternatively, units as on 31.03.2011 = (Rs. 95,000/Rs.18) = 5,277.78

Dividend as on 31.03.2012 = 5,277.78 x Rs. 10 x 0.2 = Rs.10,555.56

(2 Marks)

Let X be the NAV on 31.03.2012, then number of new units reinvested will be Rs.10,555.56/X. Accordingly 6,271.98 units shall consist of reinvested units and 5277.78 (as on 31.03.2011). Thus, by way of equation it can be shown as follows:

$$6271.98 = \frac{\text{Rs.}10,555.56}{X} + 5277.78$$

Therefore, NAV as on 31.03.2012 =Rs. 10,555.56/(6,271.98 – 5,277.78) = Rs. 10.62 **(2 Marks)**

NAV as on 31.03.2013 = Rs. 50,000 (1+0.715x33/12)/6,271.98 = Rs. 23.65 = Rs.23.65 **(1 Mark)**

Answer-3 (b) :

The London firm has to sell the USDs. It has bought a put (the put gives him the right of selling the USDs on maturity @ 1£ = 1.60$)

- Strike price (the price at which the London firm can sell $ on maturity): 1 $ = 1/1.60 ie. £ 0.625.
- On exercising the option, its buyer will get 120.00m X 0.625 ie. 75.00m £.
- Option premium is $0.0002 per £.
- Total option premium is 75.00m X 0.0002 ie. 15,000$.

(2 Marks)

15000$ = 15000/1.58 ie. £ 9493.67 (say £ 9494)

(i) If the spot price of $ on maturity is £ 0.625: ($ is stable)

- 120m$ will be sold @ £ 0.625 per USD (either in the option market or under the option).
  Gross realization = £ 75m
  Put premium = £ 9,494
  Net realization = £ 7,49,90,506

(2 Marks)

(ii) If the spot price on maturity is less than £ 0.625 per USD: ($ declines)

- 120m$ will be sold @ £ 0.625 per USD (exercising the option).

Gross realization = £ 75m
Put premium = £ 9,494
Net realization = £ 7,49,90,506

(2 Marks)

(iii) If the spot price on maturity is more than £ 0.625 per USD (USD appreciates): the net realization will be higher than £ 7,49,90,506. For example, if the $ rises to £ 0.65, the firm won't exercise the option, the $proceeds may be sold in the market and get 120m X 0.65 ie. £ 78m, the net proceeds will be 7,80,00,000-9,494 ie. £ 7,79,90,506.

(2 Marks)

Answer-4 (a) :

We are given all the items of PCPT. Hence, we can find whether arbitrage opportunity is there or not by comparing the LHS of PCPT with its RHS

LHS = Spot price + put premium = 144 + 4.50 = Rs. 148.50 **(1 Mark)**

RHS = call premium + PV of strike price = 0.70 + 148.e - 0.01
= 147.23 **(1 Mark)**

RHS is less[1] than LHS. Purchase call. Sell put. **(1 Mark)**

By selling the put, the operator is taking risk of loss in case of fall in price. To protect against risk on account of fall in prices, one should resort to short selling Le. borrow the share, sell the share, invest the sale proceeds, on maturity buy the share and return the share to its lender.

	Rs
Purchase call	-0.70
Sell put[2]	+ 4.50
Borrow[3] one share and sell the same one	+ 144
Net Cash generated	147.80

(2 Marks)

Invest Rs. 147.80. Investment proceeds =147.80.e001 = 149.29. **(1 Mark)**

If spot price on maturity is equal to strike price [Neither option will be exercised]

Profit = Investment proceeds - cost of purchasing one share on spot
= 149.29- 148= 1.29 **(1 Mark)**

Return the share to its lender.

If spot price on maturity is greater than strike price, say 149

[Put will not be exercised, call will be exercised, purchase the share (Required for returning to the lender of share on spot basis)].

Profit = Investment proceeds + receipt under call-cost of purchasing one share on spot basis
= + 149.29 + 1 - 149 = 1.29 **(1 Mark)**

Return the share to its lender.

If spot price on maturity is less than strike price, say 147

[Call will not be exercised, put will be exercised, purchase 1 share on spot basis]

Return the share to its lender. **(1 Mark)**

Profit = Investment proceeds - cost of purchasing one share on spot basis-payment to put buyer
= + 149.29 - 147 -1 = 1.29 **(1 Mark)**

For borrowing the share, we have to pay some commission to the share lender. If its amount is less than Rs.1.29,the arbitrage opportunity is there. Otherwise it is not there.

[1] It means RHS side is cheaper as compared to LHS.

[2] By selling the put, the investor has taken very heavy risk. For example, if the share price goes down to Rs. 100, the operator (the put seller) has to pay Rs. 50 to the call buyer. To protect oneself against loss arising from decline in prices, one should resort to short selling, ie. the operator should borrow the share, sell the share, invest the proceeds, purchase the share on maturity and return the share to the lender of the share. If the price declines the operator suffers loss on account of put but this loss will be compensated by purchasing the share (for returning the share to its lender) at cheaper rate.

[3] We are borrowing the share. We are not borrowing the money. We do not have to pay the price of share. We shall return the share to its lender on maturity.

Answer-4 (b) :

M/s XY Ltd.

(i) Walter's model is given by

$$P = \frac{D + (E-D)\,(r/k_e)}{K_e}$$

Where,
P = Market price per share.
E = Earnings per share = Rs. 5 (Rs. 5,00,000/ 1,00,000)
D = Dividend per share = Rs. 3 (0.60 x Rs. 5)
r = Return earned on investment = 15%
K_e = Cost of equity capital = 12%

$$P = \frac{3+(5-3)\,x\,\frac{0.1}{0.12}}{0.12} = \frac{3+2x\,\frac{0.15}{0.12}}{0.12} = Rs.45.83$$

(3 Marks)

(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 pay-out ratio of zero, the market value of the company's share will be:

$$\frac{0+(5-0)\frac{0.15}{0.12}}{0.12} = Rs.52.08$$

(3 Marks)

Answer-5 (a) :

Revision in equated Instalments
1. Determination of Unpaid principal
2. Re-Computation of EMI for revised period at revised rate

Determination of Remaining Principal

Year	Opg. Bal	Interest @10%	Total	Repaid	Clg. Bal
	Rs.	Rs.	Rs.	Rs.	Rs.
1	12,00,000	1,20,000	13,20,000	2,75,530	10,44,470
2	10,44,470	1,04,447	11,48,917	2,75,530	8,73,387

Determination of Revised Equated Monthly Installments

New Amount	Rs.8,73,387
New Period	4 years
New Rate (8% + 1%)	9%
PVAF	3.240
Installment	Rs. 8,73,387 / 3.240 =Rs. 2,69,564

Bank shall revise installment from Rs.2,75,530 to Rs. 2,69,564.

(4 Marks)

Answer-5 (b) :

Present Interest Rate
For a loan of Rs. 1,89,540 annuity being Rs. 50,000, PVAF = 3.791 (Rs. 1,89,540 / Rs. 50,000).From PVAF table for 5 years, this corresponds to 10%.
New Interest Rate
For a similar loan, annuity being Rs. 36,408, PVAF = 5.206 (Rs. 1,89,540 / Rs. 36,408). FromPVAF table for 7 years, this corresponds to 8%.
Interest Rate is prima facie beneficial.
Additional Charges
(i) Swap Charges Rs.12,000
(ii) Processing fee 3% on loan amount (3/100 × Rs. 1,89,540) Rs. 5,686
Let us compute the IRR as follows:

$$\text{Rs. 1,89,540 - Rs. 12,000 - Rs. 5,686} = \frac{36,408}{(1+IRR)^1} \ldots\ldots\ldots\ldots \frac{36,408}{(1+IRR)^7}$$

IRR = 10.947%

Since interest rate on existing loan is 10% while proposed loan is 10.947% hence proposed loan is more expensive and it is advisable not to swap. **(4 Marks)**

Answer-5 (c) :

(i) Receipt under three proposals

(a) Invoicing in Sterling

Invoicing in £ will produce = $\frac{€\ 4\ \text{million}}{1.1770}$ £ 3398471

(1 Mark)

(b) Use of Forward Contract

Forward Rate = €1.1770+0.0055 = 1.1825

Using Forward Market hedge Sterling receipt would be $\frac{€\ 4\ \text{million}}{1.1825}$ = £ 3382664

(2 Mark)

(c) Use of Future Contract

The equivalent sterling of the order placed based on future price (€1.1760)

$\frac{€4.00\ \text{million}}{1.1760}$ = £ 3401360

Number of Contracts = $\frac{€3401360}{62,500}$ = 54 Contracts (to the nearest whole number)

Thus, € amount hedged by future contract will be = 54× £62,500 = £3375000

Buy Future at	€1.1760
Sell Future at	€1.1785
	€0.0025

Total profit on Future Contracts = 54× £62,500× €0.0025 = €8438

After 6 months

Amount Received	€4000000
Add: Profit on Future Contracts	€ 8438
	€ 4008438

(4 Marks)

Sterling Receipts

On sale of € at spot = $\frac{€4008438}{1.1785}$ = €3401305

(ii) Proposal of option (c) is preferable because the option (a) & (b) produces least receipts.

(1 Mark)

Alternative solution:

Assuming that 6 month forward premium is considered as discount, because generally premium is mentioned in ascending order and discount is mentioned in descending order.

(i) Receipt under three proposals

(a) Invoicing in Sterling

Invoicing in £ will produce = $\frac{€4\ \text{million}}{1.1770}$ = £ 3398471

(b) Use of Forward Contract

Forward Rate = €1.1770-0.0055 = 1.1715

Using Forward Market hedge Sterling receipt would be $\frac{€4\ \text{million}}{1.1715}$ = £ 3414426

(c) Use of Future Contract

The equivalent sterling of the order placed based on future price (€1.1760)

= $\frac{€4.00\ \text{million}}{1.1760}$ = £ 3401360

Number of Contracts = $\frac{£3401360}{62,500}$ = 54 Contracts (to the nearest whole number)

Thus, € amount hedged by future contract will be = 54× £62,500 = £3375000

Buy Future at €1.1760

Sell Future at €1.1785
€0.0025

Total profit on Future Contracts = 54× £62,500× €0.0025 = €8438

After 6 months

Amount Received €4000000

Add: Profit on Future Contracts € 8438

€ 4008438

Sterling Receipts

On sale of € at spot = $\frac{€4008438}{1.1785}$ = €3401305

(ii) Proposal of option (b) is preferable because the option (a) & (c) produces least receipts.

Answer-6 (a) :

Assumption

(i) Rent is received in the beginning of the year. It can be invested at 10% p.a. interest.

(ii) Market price per flat, after one year given in the question, is applicable even if the flat is occupied for one year.

(iii) Cost of 5 additional flats (over and above 10 flats)
= Rs. 1025 lakhs minus Rs. 600 lakhs
= Rs. 425 lakhs
Average cost per flat (over and above 10 flats) = Rs.85 lakhs
Current selling price Rs. 80 lakhs. Hence if constructed now, the company should not construct more than 10 flats.
After 1 year, if the Selling price is Rs.91 lakhs, 15 flats may be constructed.
After 1 year, if selling price is Rs. 75 lakhs , additional 10 flats may not be constructed.

Working note:

P = $\frac{(80)(1.10)-(75+7.70)}{(91+7.70)-(75+3.70)}=\frac{5.30}{16}=0.33125$

Main Answer

(ii) Current value of land : sale value of 10 flats – cost of construction of 10 flats

= 800 lakhs minus 600 lakhs = Rs.200 lakhs

(Assumption : No profit from construction of 10 flats now)

(iii)

	Construct and sell now (10 flats)	Construct and sell after 1 year		
		If SP is 91 lakhs (15 flats)	If SP is 75 lakhs (10 flats)	Expected cash flow
Cash flow	Rs.200 lakhs	340 lakhs	150 lakhs	
Expected Cash flow after 1 year	Rs.220 lakhs			340 x 0.33125 + 150 x 0.66875 = 212.9375 lakhs

(8 Marks)

Answer-6 (b) :

Future's Price = Spot + cost of carry – Dividend

F = 220 + 220 × 0.15 × 0.25 – 0.25** × 10 = 225.75

(1 Mark)

** Entire 25% dividend is payable before expiry, which is Rs.2.50.

Thus we see that futures price by calculation is Rs.225.75 which is quoted at Rs.230 in the exchange.

(1 Mark)

Analysis:

Fair value of Futures less than Actual futures Price:

Futures Overvalued Hence it is advised to sell. Also do Arbitraging by buying stock in the cash market.

(1 Mark)

Step I

He will buy PQR Stock at Rs.220 by borrowing at 15% for 3 months. Therefore his outflows are:

Cost of Stock	220.00
Add: Interest @ 15 % for 3 months i.e. 0.25 years (220 × 0.15 × 0.25)	8.25
Total Outflows (A)	228.25

(2 Marks)

Step II

He will sell March 2000 futures at Rs.230. Meanwhile he would receive dividend for his stock.

Hence his inflows are	230.00
Sale proceeds of March 2000 futures	2.50
Total inflows (B)	232.50

(2 Marks)

Inflow – Outflow = Profit earned by Arbitrageur
= 232.50 – 228.25 = 4.25

(1 Mark)

Answer-7 (a) :

The concept of sustainable growth can be helpful for planning healthy corporate growth. This concept forces managers to consider the financial consequences of sales increases and to set sales growth goals that are consistent with the operating and financial policies of the firm. Often, a conflict can arise if growth objectives are not consistent with the value of the organization's sustainable growth. Question concerning right distribution of resources may take a difficult shape if we take into consideration the rightness not for the current stakeholders but for the future stakeholders also. To take an illustration, let us refer to fuel industry where resources are limited in quantity and a judicial use of resources is needed to cater to the need of the future customers along with the need of the present customers. One may have noticed the save fue campaign, a demarketing campaign that deviates from the usual approach of sale sgrowth strategy and preaches for conservation of fuel for their use across generation. This is an example of stable growth strategy adopted by the oil industry as a whole under resource constraints and the long run objective of survival over years.
Incremental growth strategy, profit strategy and pause strategy are other variants of stable growth strategy.

Sustainable growth is important to enterprise long-term development. Too fast or tooslow growth will go against enterprise growth and development, so financial should play important role in enterprise development, adopt suitable financial policy initiative to make sure enterprise growth speed close to sustainable growth ratio and have sustainable healthy development.

The sustainable growth rate (SGR), concept by Robert C. Higgins, of a firm is the maximum rate of growth in sales that can be achieved, given the firm's profitability, asset utilization, and desired dividend payout and debt (financial leverage) ratios. The sustainable growth rate is a measure of how much a firm can grow without borrowing more money. After the firm has passed this rate, it must borrow funds from another source to facilitate growth. Variables typically include the net profit margin on new and existing revenues; the asset turnover ratio, which is the ratio of sales revenues to total assets; the assets to beginning of period equity ratio; and the retention rate, which is defined as the fraction of earnings retained in the business.

SGR = ROE x (1- Dividend payment ratio)

Sustainable growth models assume that the business wants to: 1) maintain a target capital structure without issuing new equity; 2) maintain a target dividend payment ratio; and 3) increase sales as rapidly as market conditions allow. Since the asset to beginning of period equity ratio is constant and the firm's only source of new equity is retained earnings, sales and assets cannot grow any faster than the retained earnings plus the additional debt that the retained earnings can support. The sustainable growth rate is consistent with the observed evidence that most corporations are reluctant to issue new equity. If, however, the firm is willing to issue additional equity, there is in principle no financial constraint on its growth rate.

(4 Marks)

Answer-7 (b) :

(i) **Interest Rate Parity (IRP):** Interest rate parity is a theory which states that 'the size of the forward premium (or discount) should be equal to the interest rate differential between the two countries of

concern". When interest rate parity exists, covered interestarbitrage (means foreign exchange risk is covered) is not feasible, because any interest ate advantage in the foreign country will be offset by the discount on the forward rate. Thus, the act of covered interest arbitrage would generate a return that is no higher than what would be generated by a domestic investment.

The Covered Interest Rate Parity equation is given by:

$$\left(1+r_D\right)=\frac{F}{S}\left(1+r_F\right)$$

Where $(1 + r_D)$ = = Amount that an investor would get after a unit period by investing a rupee in the domestic market at $r_D$rate of interest and $(1+ r_F)$ F/S = is the amount that an investor by investing in the foreign market at r_F that the investment of one rupee yield same return in the domestic as well as in the foreign market.

Thus IRP is a theory which states that the size of the forward premium or discount on acurrency should be equal to the interest rate differential between the two countries of concern.

(4 Marks)

(ii) **Purchasing Power Parity (PPP):** Purchasing Power Parity theory focuses on the' inflation – exchange rate' relationship. There are two forms of PPP theory:-

The ABSOLUTE FORM, also called the 'Law of One Price' suggests that "prices of similar products of two different countries should be equal when measured in a common currency". If a discrepancy in prices as measured by a common currency exists, the demand should shift so that these prices should converge.

The RELATIVE FORM is an alternative version that accounts for the possibility of marketimperfections such as transportation costs, tariffs, and quotas. It suggests that 'because of these market imperfections, prices of similar products of different countries will not necessarily be the same when measured in a common currency.' However, it states that the rate of change in the prices of products should be somewhat similar when measured ina common currency, as long as the transportation costs and trade barriers are unchanged.

The formula for computing the forward rate using the inflation rates in domestic and foreign countries is as follows:

$$F = S\ \frac{\left(1+i_D\right)}{\left(1+i_F\right)}$$

Where F= Forward Rate of Foreign Currency and S= Spot Rate

i_D = Domestic Inflation Rate and i_F= Inflation Rate in foreign country

Thus PPP theory states that the exchange rate between two countries reflects the relative purchasing power of the two countries i.e. the price at which a basket of goods can bebought in the two countries.

(4 Marks)

Answer-7 (c) :

A very important phenomenon witnessed in the Mergers and Acquisitions scene, in recent times is one of buy - outs. A buy-out happens when a person or group of persons gain control of acompany by buying all or a majority of its shares. A buyout involves two entities, the acquirer and the target company. The acquirer seeks to gain controlling interest in the company being acquired normally through purchase of shares. There are two common types of buy-outs: Leveraged Buyouts (LBO) and Management Buy-outs (MBO). LBO is the purchase of assets or the equity of a company where the buyer uses a significant amount of debt and very little equity capital of his own for payment of the consideration for acquisition. MBO is the purchase of a business by its

management, who when threatened with the sale of its business to third parties or frustrated by the slow growth of the company, step-in and acquire the business from the owners, and run the business for themselves. The majority of buy-outs is management buy-outs and involves the acquisition by incumbent management of the business where they are employed. Typically, the purchase price is met by a small amount of their own funds and the rest from a mix of venture capital and bank debt.

Internationally, the two most common sources of buy-out operations are divestment of parts of larger groups and family companies facing succession problems. Corporate groups may seek to sell subsidiaries as part of a planned strategic disposal programme or more forced reorganization in the face of parental

financing problems. Public companies have, however, increasingly sought to dispose of subsidiaries through an auction process partly to satisfy shareholder pressure for value maximisation.

In recessionary periods, buy-outs play a big part in the restructuring of a failed or failing businesses and in an environment of generally weakened corporate performance often represent the only viable purchasers when parents wish to dispose of subsidiaries.

Buy-outs are one of the most common forms of privatisation, offering opportunities for enhancing the performances of parts of the public sector, widening employee ownership and giving managers and employees incentives to make best use of their expertise in particular sectors.

(4 Marks)