ELECTIVE PAPER 6B – FINANCIAL SERVICES AND CAPITAL MARKET

SUGGESTED SOLUTION – CASE STUDY 1

(i) The total number of subscribed shares of ABC Ltd. in November 2014 is 57,42,36,166 fully paid equity shares.

(ii)

Price Date	Closing Price at NYSE	RBI Rate	Amount in `
1-6-2015	32.21	63.6083	2048.82
2-6-2015	31.82	63.8330	2031.17
3-6-2015	32.1	63.8515	2049.63
4-6-2015	31.65	64.1775	2031.22
5-6-2015	31.81	63.8955	2032.52
8-6-2015	31.52	64.1100	2020.74
9-6-2015	31.11	63.9360	1989.05
10-6-2015	31.72	63.8849	2026.43
11-6-2015	31.25	63.8910	1996.59
12-6-2015	31.02	64.0301	1986.21
15-6-2015	31.25	64.0868	2002.71
16-6-2015	31.84	64.1505	2042.55
17-6-2015	31.92	64.1135	2046.50
18-6-2015	32.17	63.8495	2054.04
19-6-2015	31.9	63.8195	2035.84

22-6-2015	32.53	63.5098	2065.97
23-6-2015	32.22	63.6406	2050.50
24-6-2015	31.52	63.6600	2006.56
25-6-2015	16.13	63.6121	1026.06
26-6-2015	16.17	63.6042	1028.72
29-6-2015	15.86	63.9170	1013.72
30-6-2015	15.85	63.7549	1010.52

From the above data and the given exhibit, it can be seen that arbitrage opportunity is not possible in the domestic market. However, there is an arbitrage opportunity if domestic investors can purchase shares after the date of bonus issue declaration and sell their shares in the international market later after some days.

(iii) After the bonus announcement, the investors have not reacted positively. The shares are down by about ₹ 120 to ₹ 2001 levels now. The reasons for this may be because the company has pile up excess cash and it has not enough investment opportunities.

(iv) After the bonus issue, EPS will reduce. The reason is that after the bonus issue, the number of shares will increase leading to increase in denominator while numerator i.e. Profit after tax is same. This leads to fall in the value of EPS.

(v) (a) As per regulation 95 of SEBI (ICDR) Regulation, 2009, if an issuer after the approval of its board of directors which does not require the shareholders' approval for bonus issue shall implement the bonus issue within fifteen days from the date of approval of the issue by its board of directors.

However, where the issuer is required to seek shareholders' approval for bonus issue, the bonus issue shall be implemented within two months from the date of the meeting of its board of directors wherein the decision to announce the bonus issue was taken subject to shareholders' approval.

(b) While calculating basic earnings per share, profit after tax after preference dividend is divided by the total number of equity shares outstanding. On the other hand, in the computation of diluted earnings per share, debt which can be converted into equity in the future is also taken into account. Since, ABC Ltd. is a debt free company; there is no convertible debt on its part. Therefore, basis earning per share and diluted earnings per share are equal.

Further, as per Regulation 93 of SEBI (ICDR) Regulation, 2009 no company shall make a bonus issue of equity shares unless it has made reservation for holders of convertible debt instruments.

However, since ABC Ltd. is a debt free company, the above provision is not applicable to it.

(c) It is clearly provided in the SEBI Regulations that once the decision to make a bonus issue is announced, the issue cannot be withdrawn.

(vi) Prices of ABC Ltd. on the Ex-Bonus date has been reduced drastically. The basic reason is that after the bonus issue, the prices of shares come down in the immediate period. For instance, if the share price before bonus issue is Rs. 1000 and the company issues bonus shares in the ratio of 1:1, the share price after the bonus issue will be Rs. 500. However, it also means that the total market value (2 shares x Rs. 500 = 1000) remains the same.

(vii) It is generally considered prudent to pay dividend consistently even after the bonus issue. Higher dividend payout on the part of ABC Ltd. indicates that existing shareholders will get more dividend after the bonus issue.

For example, in the given case, the company issues bonus shares in the ratio of 1: 1. It declared dividend of 10% which will be ₹ 1 on the face value of ₹ 10 in the previous year. In the current year, it decides to maintain the dividend at 10%. Now, a shareholder with one share will get an additional share. His total shares will be 2. And, he is eligible for total dividend of ₹ 2 (₹ 1 x 2 shares). So, his dividend income will be doubled due to issue of bonus shares.

Therefore, higher dividend payout on the part of ABC Ltd indicates willingness on the part of company to keep the shareholders happy and increase their wealth. Also, the company can utilize it's excess cash reserves in this way.

(viii) It is definitely feasible for the company to go for buyback. As it has been given in the exhibit 1 that company's cash reserves has increased from 27,722 in 2015 to 29,176 in 2016. So, the company's burgeoning cash reserves can be utilized for buyback.

ABC Ltd has to fulfill the following conditions as given in the SEBI Regulations if it decides to go for the buyback:

(a) A company may buy-back its shares or other specified securities by any one of the following methods:—

- From the existing security-holders on a proportionate basis through the tender offer;
- From the open market through—
  - (i) book-building process,
  - (ii) Stock exchange;
- From odd-lot holders

However, it is to be noted that no offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market.

(b) A company shall not buy-back its shares or other specified securities from any person through negotiated deals, whether on or of the stock exchange or through spot transactions or through any private arrangement.

(c) Any person or an insider shall not deal in securities of the company on the basis of unpublished information relating to buy-back of shares or other specified Securities of the company.

(d) A company shall not make any offer of buy-back within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any.

(ix) The Market Price (MP) just before and after the ex-bonus date on both the stock exchanges and calculation of Price Earnings Ratio (P/E) ratio is as follows:

Ex-bonus date – 15/6/2015

P/E Ratio = Market Price Per Share/Earning Per Share

If the EPS of 31st March, 2015 has been taken

<u>ESB</u>

(MP) just before the ex-bonus date i.e. on 12/6/2015 – 1976.65

P/E Ratio = 1976.65/52.96 = 37.32

(MP) just after the ex-bonus date i.e. on 16/6/2015 – 999.45

P/E Ratio = 999.45/52.96 = 18.87

<u>ESN</u>

(MP) just before the ex-bonus date i.e. on 12/6/2015 – 1975.05

P/E Ratio = 1975.05/52.96 = 37.29

(MP) just after the ex-bonus date i.e. on 16/6/2015 – 999.35

P/E Ratio = 999.35/52.96 = 18.87

If the EPS of 31st March, 2016 has been taken

<u>ESB</u>

(MP) just before the ex-bonus date i.e. on 12/6/2015 – 1976.65

P/E Ratio = 1976.65/68.93 = 28.68

(MP) just after the ex-bonus date i.e. on 16/6/2015 – 999.45

P/E Ratio = 999.45/68.93 = 14.50

<u>ESN</u>

(MP) just before the ex-bonus date i.e. on 12/6/2015 – 1975.05

P/E Ratio = 1975.05/68.73 = 28.73

(MP) just after the ex-bonus date i.e. on 16/6/2015 – 999.35

P/E Ratio = 999.35/68.73 = 14.54

(x) The company is debt free as it can be observed from the Balance Sheet of the company. The reason for such non debt element in the capital structure of the company may be due to the fact company has large cash reserved which can be utilized for short term working capital requirements of the company. Further, the exclusion of debt in the capital structure reduces the periodic interest cost on the part of the company. Also, there is the possibility of default risk which may arise due to non-payment of interest and principal amount of loan.

(xi) As it has been given in the case study itself sufficient cash balance has been kept by the company to meet its strategic objectives. The company presently generates sufficient cash internally to finance all its operational, financing and investment requirements.

The impact of high cash holding is that the cash is underutilized and the company is losing investment opportunities. So, ABC Ltd. may consider a buyback to utilize its cash pile.

(xii) Computation of financial ratios is given as below:

(a) **Dividend Payout Ratio =** **Total dividend (including dividend tax)/Profit after tax (consolidated)**

2015	**2016**
6704/13678 x 100	6145/12372 x 100
= 49.01%	= 49.67%

(b) **Net Foreign Earnings/Earnings Ratio**

2015	**2016**
26337/52866 x 100	24113/46158 x 100
= 49.8%	= 52.2

(c) **R & D Expenditure/Revenue**

2015	**2016**
415/53983 x 100	605/47300
= 0.80	= 1.30

(d) **Net Profit Ratio = Net Profit after tax(Standalone)/Net Sales x 100**

2015	**2016**
15786/53983 x 100	12164/47300 x 100
= 29.24	= 25.71

Multiple Choice Questions

(i) (a)

(ii) (b)

(iii) (d)

(iv) (b)

(v) (c)

(vi) (a)