Current Papers Solved By
FIN 622 SUBJECTIVE PAPERS
BY ADNAN AWAN

adnanawan6@gmail.com

1) Systemic and unsystematic risk(3 M)
• **SYSTEMATIC**
• Economy-wide sources of Risk that effect all the stocks being traded in market. Systematic risk influences large number of assets and is also known as market risk.
• Systematic Risk is measured by Beta Coefficient or Beta.
• Beta measures the systematic risk inherent in an asset relative to the market as whole.

• **Systematic Risk:**
• Systematic risks are unanticipated that effects all the assets to some degree. It is no diversifiable.

••**UNSYSTEMATIC**
• It affects only specific assets or a firm. it is also known as Diversifiable or Unique or Asset- specific Risk.
It can be eliminated by Diversification therefore; a Portfolio with many assets has almost zero

Unsystematic Risk
• **Unsystematic Risk or Unique Risk:**
– It affects only specific assets or a firm. it is also known as Diversifiable or Unique or Asset- specific Risk. It can be eliminated by Diversification therefore, a Portfolio with many assets has almost zero Unsystematic Risk.

2) Capital ratio for investment (5)
A situation where a company has scarcity of funds to invest in potential opportunities and these opportunities are compared with one another in order to allocate resources most effectively and efficiently.

Question No: 49 (Marks: 3)
Explain the main features of a forward rate agreement.

Features of forward rate agreement
It is in between bank and client for fixing future interest rate on notional amount of loan. The loan is for an affirmed period starting on a particular time in future. The size of the notional loan or deposit is

decided between the bank and the client. forward rate agreement are cash settled. On settlement date buyer and seller must settle the agreement. The FRA rate for three months loan/deposit starting in a 6 months' time is normally expressed as 6v9 FRA.
The buyer of a FRA agrees to pay fixed interest rate on notional loan. At the same buyer will receive interest on notional loan at standard rate of interest. On the other side, seller of FRA agrees to pay interest on the notional amount at benchmark rate and receives interest at a fixed rate.

Question No: 50 (Marks: 3)
Differentiate between Management Buyout and Management Buy-In.

Management Buyouts
Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company and the practical consequences that follow from that. In particular, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them. The seller is also unlikely to give any but the most basic warranties to the management, on the basis that the management knows more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company. In many cases, the company will already be a private company, but if it is public then the management will take it private.

Management Buy In (MBI):
Management Buy in (MBI) occurs when a manager or a management team from **outside** the company raises the necessary finance buys it and becomes the company's new management. A management buy-in team often competes with other purchasers in the search for a suitable business. Usually, a manager will lead the team with significant experience at managing director level. The difference to a management buy-out is in the position of the purchaser: in the case of a buy-out, they are already working for the company. In the case of a buy-in, however, the manager or management team is from another source.

Question No: 51 (Marks: 5)
Assume that a bookstore uses up cash at a steady rate of Rs.300,000 per year. The interest rate is 3% and each sale of securities costs Rs.20. Determine the optimal cash balance for the bookstore.
Answer Page#95
$Q = \sqrt{2FS / i}$
Where:
S = is the amount of cash to be used in each period
F = fixed cost of obtaining new funds

i = interest cost of holding cash
Q = quantity of cash to be held per period.
Q = √ 2 FS / i
= √ [(2 7̄ 20 7̄ 300,000) / 0.03]
= √ [12000000 / 0.03]
= √ 400000000
= Rs. 20000
Optimal level of cash = √(2FT / I)
= √ [(2 7̄ 20 7̄ 300,000) / 0.03]
= √ [12000000 / 0.03]
= √ 400000000
= Rs. 20000

Question No: 52 (Marks: 5)
Firm A wants to acquire a private limited company operating in the same industry. What procedure would be followed by the **Firm A** to acquire the target company?

Question No: 53 (Marks: 5)
Why exchange rates of two currencies fluctuate? Explain briefly
Following are some factors for fluctuation:
Answer
Relative interest rates: One factor that affects exchange rates is the size of the differential between the real interest rates available to investors in the respective countries. The real interest rate is simply the nominal interest rate available to an investor in a high quality short-term investment subtracted by the country's inflation rate.
Trade imbalances: The size of any trade deficit between two countries will also affect those countries' currency exchange rates. This is because they result in an imbalance of currency reserves among the trading partners.
Political stability: If a country's government becomes unstable due to political gridlock, votes of no confidence, revolution or civil war, confidence can quickly be lost. People become less willing to accept paper currency in exchange for their goods and services, primarily because they're unsure whether they'll be able to pass the paper along to the next person.
Government involvement: The relative value of a country's currency is of great importance to its government. The value of a country's currency affects the wealth of its citizens, the competitiveness of domestically produced goods, the relative cost of the country's labor, and the country's ability to compete. As a result, governments often try to influence the relative value of their country's currencies in a number of different ways, including altering their monetary and fiscal policies, and by directly intervening in the currency markets.

Investors: Perhaps the most powerful factor that can influence exchange rates over short time frames is the role that speculators play. Investors typically have tremendous amounts of capital that they can use to either buy or sell any currency. Consequently, their actions can cause the value of such currency to fluctuate, sometimes quite significantly.

3) Levered and un levered for firm (3)

· Levered firm :

If Business has Debt & Equity (i.e. levered firm): for a levered firm range of ROE is high
LEVERED (Debt & Equity) Firm:
Higher Slope.
ROE more sensitive to changes in EBIT

· un levered firm:”

If Business is 100% Equity (or un-levered firm)
No Debt and No Interest. For un levered firm this range is very short
Un-Levered (100% Equity):
Lower ROE and Lower Risk.

4) Dividend policy and types.(5)

The policy a company uses to decide how much it will pay out to shareholders in dividends.

TYPES OF DIVIDEND

1. **Cash** (most common) are those paid out in form of **"real cash"**. It is a form of investment interest/income and is taxable to the recipient in the year they are paid. It is the most common method of sharing corporate profits.
2. **Stock or Scrip dividends** (common) are those paid out in form of **additional stock shares** of the issuing corporation, or other corporation (e.g., its subsidiary corporation). They are usually issued in proportion to shares owned (e.g., for every 100 shares of stock owned, 5% stock dividend will yield 5 extra shares). This is very similar to a stock split in that it increases the total number of shares while lowering the price of each share and does not change the market capitalization
3. **Property or dividends in specie** are those paid out in form of **assets** from the issuing corporation, or other corporation (e.g., its subsidiary corporation). Property dividends are usually paid in the form of products or services provided by the corporation. When paying property dividends, the corporation will often use securities of other companies owned by the issuer.

Question No: 45 (Marks: 3)
Give at least three sources of synergies and explain each of them briefly.

Staff reductions - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff

members from accounting, marketing and other departments.
Economies of scale - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. When placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
Acquiring new technology - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can maintain or develop a competitive edge.

Question No: 46 (Marks: 5)
How would you expect the firm's cash balance to respond to the following changes?
a) Interest rates increase.
b) The volatility of daily cash flow decreases
c) The transaction cost of buying or selling marketable securities goes up

Question No: 47 (Marks: 5)
The Inventory Manager of a firm has given the following data:
Consumption per Period = S = 4000 Units
Economic Order Quantity = EOQ = 80 Units
Lead Time = L = 1 Month
Stock out Acceptance Factor = F = 1.10
Requirement:
Determine the Economic Order Point for the firm.
Solution:
EOP = SL + F √S x EOQ x L
Where
S= Consumption Per Period
L= Lead Time
F= Stock out Acceptance Factor
EOQ = Economic Order Quantity
S = 4000 Units
EOQ = 80 Units
L = 1 Month
F= 1.10 (This Represents The Stock out level of say, 10%)
EOP = SL + F √S x EOQ x L
= 4000 x 1 + 1.10 √4000 x80 x 1
= 4622.25 Units

Question No: 48 (Marks: 5)
How a firm can create a money market hedge against transaction exposure, when the firm has to make a payment at some future date?

Money Market Hedge – future FCY payment scenario
A similar approach will be taken to create the hedge when a firm is expecting to pay in FCY in future. In this scenario, a hedge can be created by exchanging local currency for

FCY now using spot rates and putting the currency on deposit until the future payment is to be made. The amount borrowed and the interest earned on the deposit should be equal to the FCY. If it is not the case then it will not be a clean hedge. The cash flows are fixed because the cost in local currency is the cost of buying FCY on spot rates that was put under a deposit.

Mechanism:
Step 1: determine the FCY (assume US $) amount to be put to a deposit that will grow exactly to equalize the future payment in dollars. You need to calculate this using the available spot rates and interest rate on dollar deposit.
Step 2: in order to deposit dollars in interest bearing account, the company will buy dollars at spot rates.
Step 3: the company will borrow local currency for the period of hedge. These steps will ensure that the hedge created a definite cash flow regardless of exchange rate or interest rate fluctuations. The exchange rate has been fixed.

Question No: 49 (Marks: 10)
Describe in detail the major steps in short term financial planning process of a firm.

The Financial Planning Process consists of the Following five Steps
1. **Establishing and defining the client-planner relationship.**
The financial planner should clearly explain or document the services to be provided to you and define both
his and your responsibilities. The planner should explain fully how he will be paid and by whom.
You and the planner should agree on how long the professional relationship should last and on how decisions will be made.
2. **Gathering client data, including goals.**
The financial planner should ask for information about your financial situation. You and the planner should mutually define your personal and financial goals, understand your time frame for results and discuss, if relevant, how you feel about risk. The financial planner should gather all the necessary documents before giving you the advice you need.

3. **Analyzing and evaluating your financial status.**
The financial planner should analyze your information to assess your current situation and determine what
you must do to meet your goals. Depending on what services you have asked for, this could include analyzing
your assets, liabilities and cash flow, current insurance coverage, investments or tax strategies.
4. **Developing and presenting financial planning recommendations and/or alternatives.**
The financial planner should offer financial planning recommendations that address your goals, based on the information you provide. The planner should go over the recommendations with you to help you understand them so that you can make informed

decisions. The planner should also listen to your concerns and revise the recommendations as appropriate.
5. **Implementing the financial planning recommendations.**
You and the planner should agree on how the recommendations will be carried out. The planner may carry out the recommendations or serve as your "coach," coordinating the whole process with you and other professionals such as attorneys or stockbrokers.

Q 3.Compare and contrast the Stable Dividend per share policy and Constant dividend payout policy. Marks 5

CONSTANT DIVIDEND PAYOUT
• A fixed %age is paid out as dividend.
• Under this policy the dividend amount will vary because the net income is not constant.
• **STABLE DIVIDEND PER SHARE:**
• per share fixed amount of dividend paid every year.
• Look favorably by investors and implies low risk firm.
• Investors can easily forecast and predict their earnings.
• Aid in financial planning
•
Important For Short Questions:
AGGRESSIVE AND DEFENSIVE STOCKS:
• Aggressive Stocks have high betas, greater than 1, meaning that their return is more than one-to-one to changes in return of overall market.
• Defensive stock are less volatile to change in market return and have beta of less than one

Question No: 50 (Marks: 3)
Differentiate between Management Buyout and Management Buy-In.
Management Buyouts
Management buyouts are similar in all major legal aspects to any other acquisition of a company. The particular nature of the MBO lies in the position of the buyers as managers of the company and the practical consequences that follow from that. In particular, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them. The seller is also unlikely to give any but the most basic warranties to the management, on the basis that the management knows more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company. In many cases, the company will already be a private company, but if it is public then the management will take it private.

Management Buy In (MBI):
Management Buy in (MBI) occurs when a manager or a management team from **outside** the company raises the necessary finance buys it and becomes the company's new management. A management buy-in team often competes with other purchasers in the search for a suitable business. Usually, a manager will lead the team with significant experience at managing director level. The difference to a management buy-out is in the

position of the purchaser: in the case of a buy-out, they are already working for the company. In the case of a buy-in, however, the manager or management team is from another source.

Question No: 51 (Marks: 5)
Assume that a bookstore uses up cash at a steady rate of Rs.300,000 per year. The interest rate is 3% and each sale of securities costs Rs.20. Determine the optimal cash balance for the bookstore.

Optimal level of cash = $\sqrt{(2FT / I)}$
$= \sqrt{[(2 \times 20 \times 300,000) / 0.03]}$
$= \sqrt{[12000000 / 0.03]}$
$= \sqrt{400000000}$
= Rs. 20000

Question No: 52 (Marks: 5)
Firm A wants to acquire a private limited company operating in the same industry. What procedure would be followed by the **Firm A** to acquire the target company?
Why exchange rates of two currencies fluctuate? Explain briefly
Following are some factors for fluctuation:

Relative interest rates: One factor that affects exchange rates is the size of the differential between the real interest rates available to investors in the respective countries. The real interest rate is simply the nominal interest rate available to an investor in a high quality short-term investment subtracted by the country's inflation rate.

Trade imbalances: The size of any trade deficit between two countries will also affect those countries' currency exchange rates. This is because they result in an imbalance of currency reserves among the trading partners.

Political stability: If a country's government becomes unstable due to political gridlock, votes of no confidence, revolution or civil war, confidence can quickly be lost. People become less willing to accept paper currency in exchange for their goods and services, primarily because they're unsure whether hey'll be able to pass the paper along to the next person.

Government involvement: The relative value of a country's currency is of great importance to its government. The value of a country's currency affects the wealth of its citizens, the competitiveness of domestically produced goods, the relative cost of the country's labor, and the country's ability to compete. As a result, governments often try to influence the relative value of their country's currencies in a number of different ways, including altering their monetary and fiscal policies, and by directly intervening in the currency markets.

Investors: Perhaps the most powerful factor that can influence exchange rates over short time frames is the role that speculators play. Investors typically have tremendous amounts of capital that they can use to either buy or sell any currency. Consequently, their actions can cause the value of such currency to fluctuate, sometimes quite significantly.

Adnanawan6@gmail.com