**Financial Management**

**NMIMS Solved Assignments for December 2024**

**1. In the context of financial management, discuss the concepts of wealth maximization and profit maximization. What are the key differences between the two? Which concept is more appropriate for guiding the financial decisions of a corporation? (Student can make any assumptions to further explanation of their view point).**

**Answer:**

**Introduction:**

In financial management, the objectives of a firm often pivot between wealth maximization and profit maximization. Wealth maximization focuses on increasing the overall value of the company and its shareholders' wealth, typically reflected in the long-term stock price and market value. In contrast, profit maximization aims to enhance short-term earnings, often measured through net profits. Both concepts are integral to corporate finance, influencing decision-making and strategic planning. However, they embody distinct philosophies that can lead to different outcomes for a firm. This discussion will delve into the definitions, differences, and implications of each approach, ultimately advocating for the superiority of wealth maximization as a guiding principle for corporate financial decisions. By emphasizing long-term growth and sustainability, wealth maximization aligns better with the interests of stakeholders and contributes to overall economic stability.

**This is partially solved sample answer**

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**2. RK Ltd has a stock with a beta of 1.3 and an expected return of 16.7%. The current risk-free rate is 7.6%. Explain how CAPM determines the expected return of a stock based on its risk relative to the market and calculate the risk premium on the market. Show the step-by-step calculation.**

**Answer:**

**Introduction:**

The Capital Asset Pricing Model (CAPM) is a financial model that determines the expected return of an investment based on its risk relative to the market. According to CAPM, the expected return of a stock is a function of the risk-free rate, the stock's beta (a measure of its sensitivity to market movements), and the expected market return. The model emphasizes that investors should be compensated for the time value of money (risk-free rate) and the risk associated with the investment (market risk premium). By understanding the relationship between risk and return, investors can make informed decisions about their investment portfolios. In this scenario, we have RK Ltd with a specific beta and expected return, allowing us to analyze the risk premium on the market using CAPM.

CAPM Formula

The formula for CAPM is:

$$E\left(R\_{i}\right)=R\_{f}+β\_{i}\left(E\left(R\_{m}\right)-R\_{f}\right)$$

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**3. A company is considering its capital structure to minimize its overall cost of capital. The company's current capital structure consists of 40% debt and 60% equity. The cost of debt is 6%, and the cost of equity is 12%. The company is evaluating a new capital structure with 50% debt and 50% equity, where the cost of debt will increase to 7% due to higher financial risk, while the cost of equity will rise to 14%. (Assume corporate tax rate 30%)**

**a. Calculate the weighted average cost of capital (WACC) for the company's current and proposed capital structures.**

**Answer:**

**Introduction:**

When a company seeks to optimize its capital structure, it aims to minimize its overall cost of capital while maintaining a balance between debt and equity financing. The Weighted Average Cost of Capital (WACC) is a key metric in this evaluation, as it reflects the average rate that a company is expected to pay its security holders to finance its assets. This analysis will compare the WACC of the company’s current capital structure with a proposed structure to determine the most cost-effective financing strategy.

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**b. Based on the WACC calculated in part (a), determine the optimal capital structure for the company. Discuss the trade-offs involved in choosing between a lower cost of debt and a potentially higher financial risk.**

**Answer:**

**Introduction:**

In corporate finance, determining the optimal capital structure is crucial for minimizing the overall cost of capital while maximizing shareholder value. This involves balancing debt and equity financing, as each option carries different costs and risks. The Weighted Average Cost of Capital (WACC) serves as a critical indicator for this decision. By analyzing the WACC for different capital structures, companies can make informed choices about financing, considering both the potential benefits of lower costs and the inherent risks associated with increased debt.

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