Practice Questions on Capital Structure & Its Theories

Q1. Explain the assumptions and implications of the Net Income approach and Net Operating Income approach. Illustrate your answer with hypothetical example.

Q2. (i) A company expects a net operating income of Rs. 1,00,000. It has Rs. 5,00,000, 6% debentures. The overall capitalization rate is 10%. Calculate the value of the firm and equity capitalization rate according to the Net Operating Income Approach.

(ii) If the debenture increases to Rs. 7,50,000, what will be the effect on value of the firm and cost of equity?

Q3. Firm X and Y are identical in every respect except that firm Y is levered while X is unlevered. Company Y has Rs. 20,00,000 of 8% debentures outstanding. The tax rate is 50%. EBIT is Rs. 6,00,000 and equity capitalization rate is 10% for company Y. What would be the value of both the firms according to MM approach?

Q4. The firms A & B are identical in all respects including risks factors except for debt equity mix. Firm A has issued 12% debentures of Rs. 15 Lakhs while B has issued only equity.
Both firms earn 30% before interest and taxes on their total assets of Rs. 25 Lakhs.
Assuming a tax rate of 50% and capitalization rate of 20 % for an all-equity company, you are required to compute the value of the two firms using:

(i) NI Approach
(ii) NOI Approach