

CAPITAL STRUCTURE

Problem No. 1

Paramount Produces Ltd. wants to raise ₹ 100 lakhs for a diversification project. Current estimate of EBIT from the new projects is ₹ 22 lakhs p.a. Cost of debt will be 15% for amounts up to and including ₹ 40 lakhs, 16% for additional amounts up to and including ₹ 50 lakhs and 18% for additional amounts above ₹ 50 lakhs. The equity shares (face value ₹ 10) of the company have a current market value of ₹ 40. This is expected to fall to ₹ 32 if debts exceeding ₹ 50 lakhs are raised. The following options are under consideration of the company:

Option	Equity	Debt
A	50%	50%
B	60%	40%
C	40%	60%

Determine the earning per share (E.P.S.) for each option and state which option the company should exercise. Tax rate applicable to the company is 50%.

Answer

Calculation of no. of Equity shares

Particulars	₹ in lakhs		
	Plan A	Plan B	Plan C
ESC	50	60	40
Debt	50	40	60
Issue price	40	40	32
Shares to be issued	1.25	1.50	1.25

Interest calculation

Plant A (Debt = 50 lakh)

$$(40 \text{ lakh} \times 15\%) + (10 \text{ lakh} \times 16\%)$$

7,60,000

Plant B (Debt = 40 lakh)

$$(40 \text{ lakh} \times 15\%)$$

6,00,000

Plant C (Debt = 60 lakh)

$$(40 \text{ lakh} \times 15\%) + (10 \text{ lakh} \times 16\%) + (10 \text{ lakh} \times 18\%)$$

9,40,000

Statement showing EPS under alternative plans

Particulars	Plan A	Plan B	Plan C
EBIT	22,00,000	22,00,000	22,00,000
- Interest	7,60,000	6,00,000	9,40,000
EBT	14,40,000	16,00,000	12,60,000
- tax @ 50%	7,20,000	8,00,000	6,30,000
Earnings to ESH	7,20,000	8,00,000	6,30,000
÷ No. of equity shares	1,25,000	1,50,000	1,25,000
EPS	5.76	5.33	5.04

The company should opt Plan A as EPS is higher comparatively

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Problem No. 2

Bhaskar Manufacturer Ltd. has Equity Share Capital of ₹ 5,00,000 (face value ₹ 100). To meet the expenditure of an expansion program, the company wishes to raise ₹ 3,00,000 and is having following four alternative sources to raise the funds:

- Plan A** To have full money from the issue of Equity shares.
- Plan B** To have ₹ 1,00,000 form Equity and ₹ 2,00,000 from borrowings from the financial institutions @10% per annum.
- Plan C** Full money from borrowings @ 10% per annum.
- Plan D** ₹ 1,00,000 in Equity and ₹ 2,00,000 from 8% Preference Shares.

The company earnings after expansion will be ₹ 1,50,000. The tax is 50%. Select a suitable plan out of the above four plans to raise the required funds.

Answer

Calculation of no.of Equity shares

Particulars	Plan A	Plan B	Plan C	Plan D
ESC	3,00,000	1,00,000	-	1,00,000
Debentures	-	2,00,000	3,00,000	-
8% P.S.C	-	-	-	2,00,000
Issue price	100	100	-	100
Additional shares	3,000	1,000	-	1,000
Existing shares	5,000	5,000	5,000	5,000
Total no. of shares	8,000	6,000	5,000	6,000

Statement showing EPS under alternative plans

Particulars	Plan A	Plan B	Plan C	Plan D
EBIT	1,50,000	1,50,000	1,50,000	1,50,000
- Interest	-	20,000	30,000	-
EBT	1,50,000	1,30,000	1,20,000	1,50,000
- tax @ 50%	75,000	65,000	60,000	75,000
EAT	75,000	65,000	60,000	75,000
- Pref div	-	-	-	16,000
Earnings to ESH	75,000	65,000	60,000	59,000
÷ No. of equity shares	8,000	6,000	50,000	6,000
EPS	9.38	10.83	1.20	9.83

The company should opt Plan C as EPS is higher comparatively.

Problem No. 3

A company earn a profit of ₹ 3,00,000 p.a. after meeting its interest Liability of ₹ 1,20,000 on 12% Debenture. The tax rate is 50%. The number of equity shares of ₹ 10 each are 80,000 and retained earning amount to ₹12,00,000. The company propose to take up an expansion scheme for which a sum of ₹ 4,00,000 is required. It is anticipated that after expansion, the company will be able to achieve the same return on

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investment as at present. The fund required for expansion can be raised either through debt at the rate of 12% **OR** by issuing share at par.

Required:

1. Compute the earning per share (EPS) if :
 - the additional funds were raised as debt
 - the additional funds were raised by issue of equity shares
2. Advise the company as to which source of finance is preferable.

Answer

In the given question, there are two plans, i.e.

- A. Raising fund by debt @ 12%; or
- B. Issuing the shares at par

Calculation of total capital employed

Equity share capital (80,000 * 10)	8,00,000
12% debentures (1,20,000 / 12%)	10,00,000
Retained Earnings	12,00,000
Total capital Employed	30,00,000

Calculation of earnings before interest and tax

Earnings after interest	3,00,000
+ Interest	1,20,000
EBIT	4,20,000

Calculation of return on investment

ROI = EBIT/ Capital Employed = 4,20,000/ 30,00,000 * 10 = 14%;

Therefore, earning after expansion = 34,00,000 * 14% = 4,76,000

Calculation of no. of Equity shares

Particulars	Plan 1	Plan 2
Debt	4,00,000	-
Equity	-	400,000
Issue price	-	10
Additional shares	-	40,000
Existing shares	80,000	80,000
Total no. of shares	80,000	1,20,000

Particulars	Plan A	Plan B
EBIT	4,76,000	4,76,000
- Interest (existing)	1,20,000	1,20,000
- interest (additional)	48,000	-
EBT	3,08,000	3,56,000
- tax @ 50%	1,54,000	1,78,000
EAT	1,54,000	1,78,000
÷ No. of equity shares	80,000	1,20,000

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EPS	4.00	7.20	6.40
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(ii) Calculation of Financial Break-even point

Financial break-even point is the earnings which are equal to the fixed finance charges and preference dividend.

Plan A : Under this plan there is no interest or preference dividend payment hence, the Financial Break-even point will be zero.

Plan B : Under this plan there is an interest payment of ₹8,000 and no preference dividend, hence, the Financial Break-even point will be ₹8,000 (Interest charges).

Plan C : Under this plan there is no interest payment but an after tax preference dividend of ₹8,000 is paid. Hence, the Financial Break-even point will be before tax earnings of ₹16,000 (i.e. ₹8,000 ÷ 0.5 = ₹16,000.)

(iii) Computation of indifference point between the plans.

$$\frac{(EBIT - PD) / (1 - T) - PD}{\text{number of shares}} = \frac{(EBIT - PD) / (1 - T) - PD}{\text{number of shares}}$$

a. Indifference point between Plan A & Plan B

$$\frac{(EBIT - 0)(1 - 0.5)}{10,000} = \frac{(EBIT - 8,000)(1 - 0.5)}{5,000}$$

$$0.5 \text{ EBIT (5,000)} = (0.5 \text{ EBIT} - 4,000) (10,000)$$

$$0.5 \text{ EBIT} = \text{EBIT} - 8,000$$

$$0.5 \text{ EBIT} = 8,000$$

$$\text{EBIT} = ₹16,000$$

When EBIT is ₹ 16,000 – Plan A EPS = Plan B EPS.

b. Indifference point between Plan A & Plan C

$$\frac{(EBIT - 0)(1 - 0.5)}{10,000} = \frac{(EBIT - 0)(1 - 0.5) - 8,000}{5,000}$$

$$0.5 \text{ EBIT (5,000)} = (0.5 \text{ EBIT} - 8,000) (10,000)$$

$$0.25 \text{ EBIT} = 0.5 \text{ EBIT} - 8,000$$

$$0.25 \text{ EBIT} = 8,000$$

$$\text{EBIT} = ₹32,000$$

When EBIT is ₹ 32,000 – Plan A EPS = Plan B EPS.

c. Indifference point between Plan B & Plan C

$$\frac{(EBIT - 8,000)(1 - 0.5)}{5,000} = \frac{(EBIT - 0)(1 - 0.5) - 8,000}{5,000}$$

$$0.5 \text{ EBIT} - 4,000 = 0.5 \text{ EBIT} - 8,000$$

$$(5,000) = (5,000)$$

$$0.5 \text{ EBIT} - 4,000 = 0.5 \text{ EBIT} - 8,000$$

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There is no indifference point between the financial plans B and C.

It can be seen that Financial Plan B dominates Plan C. Since, the financial break-even point of the former is only ₹8,000 but in case of latter it is ₹16,000. Further EPS of plant B is the highest.

Problem No. 5

Calculate the market value of three firms under NI and NOI approach

Particulars	A Ltd	B Ltd	C Ltd
10% Debt	Nil	2,50,000	5,00,000
EBIT ₹	2,00,000	2,00,000	2,00,000

Equity capitalisation rate 20%. Ignore income tax.

Answer

Statement showing MV of the firm (NI Approach)

Particulars	A Ltd.	B Ltd.	C Ltd.
EBIT	2,00,000	2,00,000	2,00,000
- Interest @10%	-	25,000	50,000
Available to ESH	2,00,000	1,75,000	1,50,000
Ke	20%	20%	20%
MV of shares	10,00,000	8,75,000	7,50,000
MV of debt	-	2,50,000	5,00,000
MV of firms	10,00,000	11,25,000	12,50,000

In case of unlevered firm $K_e = WACC$

Statement showing MV of the firm (NOI Approach)

Particulars	A Ltd.	B Ltd.	C Ltd.
EBIT	2,00,000	2,00,000	2,00,000
- Interest @10%	-	25,000	50,000
Available to ESH	2,00,000	1,75,000	1,50,000
WACC	20%	20%	20%
MV of Firm	10,00,000	10,00,000	10,00,000
- MV of debt	-	2,50,000	5,00,000
MV of equity	10,00,000	7,50,000	5,00,000
Ke	20.00%	23.33%	30.00%

Problem No. 6

Assuming no taxes and given the earnings before interest and taxes (EBIT), interest (I) at 10% and equity capitalisation rate (K_e) below, calculate the total market value of each firm and WACC of each firm.

Firms	EBIT	Interest	K_e (percent)
X	₹ 2,00,000	₹ 20,000	12
Y	3,00,000	60,000	16
Z	5,00,000	2,00,000	15
W	6,00,000	2,40,000	18

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Answer

Statement showing MV of the firm

Particulars	X	Y	Z	W
EBIT	2,00,000	3,00,000	5,00,000	6,00,000
- Interest @10%	20,000	60,000	2,00,000	2,40,000
Available to ESH	1,80,000	2,40,000	3,00,000	3,60,000
Ke	12%	16%	15%	18%
MV of shares	15,00,000	15,00,000	20,00,000	20,00,000
MV of debt	2,00,000	6,00,000	20,00,000	24,00,000
MV of firms	17,00,000	21,00,000	40,00,000	44,00,000
WACC (EBIT/Firm MV)	11.76%	14.29%	12.50%	13.64%

Problem No. 7

Manufacturing Co., has a total capitalisation of ₹ 10,00,000 and normally earns ₹ 1,00,000 (before interest and taxes). The financial manager of the firm wants to take a decision regarding the capital structure. After a study of the capital market, he gathers the following data:

Amount of Debt	Interest Rate	Ke%
0	--	10.00
1,00,000	4.0	10.50
2,00,000	4.0	11.00
3,00,000	4.5	11.60
4,00,000	5.0	12.40
5,00,000	5.5	13.50
6,00,000	6.0	16.00
7,00,000	8.0	20.00

- What amount of debt should be employed as per traditional approach;
- If the Modigliani-Miller approach is followed, what should be the equity capitalization rate? Assume there is **no income tax**.

Answer

Statement showing MV of the firm (Traditional Approach)

Particulars	D = 0	D = 1	D = 2	D = 3	D = 4
EBIT	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
- Interest	-	4,000	8,000	13,500	20,000
Available to ESH	1,00,000	96,000	92,000	86,500	80,000
Ke	10.00%	10.50%	11.00%	11.60%	12.40%
MV of shares	10,00,000	9,14,286	8,36,364	7,45,690	6,45,161
MV of debt	-	1,00,000	2,00,000	3,00,000	4,00,000
MV of firms	10,00,000	10,14,286	10,36,364	10,45,690	10,45,161

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Particulars	D = 5	D = 6	D = 7
EBIT	1,00,000	1,00,000	1,00,000
- Interest	27,500	36,000	56,000
Available to ESH	72,500	64,000	44,000
K_e	13.50%	16.00%	20.00%
MV of shares	5,37,037	4,00,000	2,20,000
MV of debt	5,00,000	6,00,000	7,00,000
MV of firms	10,37,037	10,00,000	9,20,000

When the debt amount = 3,00,000, the firm value is higher so that is the best capital structure.

Statement showing K_e (MM Approach)

Particulars	D = 0	D = 1	D = 2	D = 3	D = 4
EBIT	1,00,000	1,00,000	1,00,000	1,00,000	1,00,000
- Interest	-	4,000	8,000	13,500	20,000
Available to ESH	1,00,000	96,000	92,000	86,500	80,000
WACC	10.00%	10.00%	10.00%	10.00%	10.00%
MV of firms	10,00,000	10,00,000	10,00,000	10,00,000	10,00,000
- MV of debt	0	1,00,000	2,00,000	3,00,000	4,00,000
MV of equity	10,00,000	9,00,000	8,00,000	7,00,000	6,00,000
K_e	10%	10.67%	11.50%	12.36%	13.33%

Particulars	D = 5	D = 6	D = 7
EBIT	1,00,000	1,00,000	1,00,000
- Interest	27,500	36,000	56,000
Available to ESH	72,500	64,000	44,000
WACC	10.00%	10.00%	10.00%
MV of firms	10,00,000	10,00,000	10,00,000
- MV of debt	5,00,000	6,00,000	7,00,000
MV of equity	5,00,000	4,00,000	3,00,000
K_e	14.50%	16.00%	14.67%

Problem No. 8

XYZ Ltd. has Earnings before interest and taxes (EBIT) of ₹ 4,00,000. The firm currently has outstanding debts of ₹ 15,00,000 at an average cost, k_d , of 10%. Its cost of equity capital k_e , is estimated to be 16%.

- i. Determine current value of the firm using the Traditional approach.
- ii. Determine the firm's overall capitalization rate, k_o
- iii. The firm is considering issuing capital of ₹ 5,00,000 in order to redeem ₹ 5,00,000 debt. The cost of debt is expected to be unaffected. However, the

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firm's cost of equity capital is to be reduced to 14% as a result of decrease in leverage. Would you recommended the proposed action?

Answer

(i)&(ii) Statement showing MV of the firm (Traditional Approach)

Particulars	Existing
EBIT	4,00,000
- Interest @10%	1,50,000
Available to ESH	2,50,000
Ke	16%
MV of shares	15,62,500
MV of debt	15,00,000
MV of firm	30,62,500
WACC	13.06%

Under the proposed plan, Debt amount will be ₹ 10 lakh. Let us check the market value of firm under this plan. If it is higher compared to existing, we will recommend the same.

(iii)Statement showing MV of the firm (Traditional Approach) (Proposed plan)

Particulars	Existing
EBIT	4,00,000
- Interest @10%	1,00,000
Available to ESH	3,00,000
Ke	14%
MV of shares	21,42,857
MV of debt	10,00,000
MV of firms	31,42,857
WACC	12.73%

Accepted as MV of firm is higher in this proposal.

Problem No. 9

Z Ltd. operating income (before interest and tax) is ₹ 9,00,000. The firm cost of debt is 10% , and currently firm employs ₹ 30,00,000 of debt. Its overall cost of capital is 12%. Calculate cost of equity.

Answer

Statement showing Ke

Particulars	₹
EBIT	9,00,000
- Interest	3,00,000
Available to ESH	6,00,000
WACC	12.00%
MV of firms	75,00,000
- MV of debt	30,00,000

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MV of equity	45,00,000
Ke	13.33%

Problem No. 10

Given (i) the EBIT of ₹ 2,00,000 (ii) the corporate tax rate of 35% and (iii) the following data, determine the amount of debt that should be used by the firm in its capital structure to **maximize the value of the firm**.

Debt	Interest rate (%)	Ke (%)
Nil	Nil	12
1,00,000	10	12
2,00,000	10.5	12.6
3,00,000	11	13
4,00,000	12	13.6
5,00,000	14	15.6
6,00,000	17	20

Answer

Statement showing MV of the firm

Particulars	D = 0	D = 1	D = 2	D = 3	D = 4	D = 5	D = 6
EBIT	2,00,000	2,00,000	2,00,000	2,00,000	2,00,000	2,00,000	2,00,000
- Interest	-	10,000	21,000	33,000	48,000	70,000	1,02,000
EBT	2,00,000	1,90,000	1,79,000	1,67,000	1,52,000	1,30,000	98,000
- tax @ 35%	70,000	66,500	62,650	58,450	53,200	45,500	34,300
EAT	1,30,000	1,23,500	1,16,350	1,08,550	98,800	84,500	63,700
Ke	12%	12%	12.6%	13%	13.6%	15.6%	20%
MV of shares	10,83,333	10,29,167	9,23,413	8,35,000	7,26,471	5,41,667	3,18,500
MV of debt	-	1,00,000	2,00,000	3,00,000	4,00,000	5,00,000	6,00,000
MV of firms	10,83,333	11,29,167	11,23,413	11,35,000	11,26,471	10,41,667	9,18,500
Ke	12%	17.71%	17.80%	17.62%	17.75%	19.20%	21.77%

The 3,00,000 amount of debt will be used by the firm as MV of firm is more.

Problem No. 11

From the following selected data, determine the value of the firms, P and Q belonging to the **homogeneous risk class** under (a) the Net Income (NI) approach, and (b) the

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Net Operating Income (NOI) approach.

Particular	Firm P	Firm Q
EBIT	₹ 2,25,000	₹ 2,25,000
Interest at 15%	75,000	
Equity capitalization rate, K_e	20%	
Corporate tax rate	50%	

Answer

(a) Statement showing MV of the firms under NI approach

Particulars	Firm P	Firm Q
EBIT	2,25,000	2,25,000
- Interest	75,000	-
EBT	1,50,000	2,25,000
- tax @ 50%	75,000	1,12,500
EAT	75,000	1,12,500
K_e	20%	20%
MV of shares	3,75,000	5,62,500
MV of debt	5,00,000	-
MV of firms	8,75,000	5,62,500

Calculation of WACC of Firm P

Source	MV	Weight	Cost	W x C
MV of shares	3,75,000	0.43	20	8.57
MV of debt	5,00,000	1	7.50	4.29
	8,75,000	1.00		12.86

Cost of debt (K_d) = 15% (1-0.5)
= 7.5%

Firm Q = K_e as there is no debt i.e. 100% equity;

(b) Statement showing MV of the firms under NOI approach

Particulars	Firm P	Firm Q
EBIT	2,25,000	2,25,000
- Interest	75,000	-
EBT	1,50,000	2,25,000
- tax @ 50%	75,000	1,12,500
EAT	75,000	1,12,500
K_e	24%	20%
MV of shares	3,12,500	5,62,500
MV of debt	5,00,000	-
MV of firms	8,12,500	5,62,500

Debt amount = 75,000 / 15% = ₹ 5,00,000;

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MV of firm P (Levered firm) = MV of firm Q + (debt x tax rate) =
 $5,62,500 + (5,00,000 \times 50\%) = 8,12,500$

Calculation of WACC

Source	MV	Weight	Cost	WxC
MV of shares	3,12,500	0.38	24	9.23
MV of debt	5,00,000	0.62	7.50	4.62
	8,12,500	1.00		13.85

Cost of debt (Kd) = 15% (1-0.5)
 = 7.5%

Firm Q = Ke as there is no debt i.e. 100% equity;

Problem No. 12

There are two firms P and Q which are **identical except P does not use debt** in its capital structure while Q has ₹ 8,00,000, 9% debenture in its capital structure. Both the firm have earnings before interest and tax of ₹ 2,60,000 p.a. and the capitalization rate is 10%.

Assuming the corporate tax of 30%, Calculate the value of these firms according to MM Approach;

Answer

Calculation of Market value of firm

Particulars	Firm P	Firm Q
EBIT	2,60,000	2,60,000
- Interest (8,00,000 x 9%)	-	72,000
EBT	2,60,000	1,88,000
- tax @ 30%	78,000	56,400
EAT	1,82,000	1,31,600
MV of shares	18,20,000	12,60,000
MV of debt	-	8,00,000
MV of firms (note)	18,20,000	20,60,000

MV of firm P (Levered firm) = MV of firm Q + (debt x tax rate) =
 $18,20,000 + (8,00,000 \times 30\%) = 20,60,000$

Problem No. 13

The following figures are made available to you:

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As it is below 60% = PE Ratio will remain same

Existing PE Ratio (109.70 / 8.4375) 13

If new capital is received through Equity issue

Debenture	D	10,00,000
ESC + R&S (i.e. Equity) + New issue		32,00,000
	D + E	42,00,000
Debt equity ratio i.e. debt / (D+E)		24%

As it is below 60% = PE Ratio will remain same

Existing PE Ratio (109.70 / 8.4375) 13

Calculation of number of equity shares

	Loan	Equity
Equity capital to be issued	-	10,00,000
New issue price	-	100
New number of shares	-	10,000
Existing shares	1,00,000	1,00,000
Total number of shares	1,00,000	1,10,000

Calculation of probable price of equity share

	Loan	Equity
EBIT	23,62,500	23,62,500
- Existing interest (10 L * 15%)	1,50,000	1,50,000
- Interest on new loan (10 L * 18%)	1,80,000	-
PBT	20,32,500	22,12,500
Less Tax @50%	10,16,250	11,06,250
PAT	10,16,250	11,06,250
Number of equity shares	1,00,000	1,10,000
EPS	10.16	10.06
PE Ratio	13	13
Market price per share	132.11	130.74

Problem No. 14

Best of Luck Ltd., a profit-making company, has a paid-up capital of ₹ 100 lakhs consisting of 10 lakhs ordinary shares of ₹ 10 each. Currently, it is earning an annual pre-tax profit of ₹ 60 lakhs. The company's shares are listed and are quoted in the range of ₹ 50 to ₹ 80. The management wants to diversify production and has approved a project which will cost ₹ 50 lakhs and which is expected to yield a pre-tax income of ₹ 40 lakhs per annum. To raise this additional capital, the following options are under consideration of the management:

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- (a) To issue equity share capital for the entire additional amount. It is expected that the new shares (face value of ₹ 10) can be sold at a premium of ₹ 15.
- (b) To issue 16% non-convertible debentures of ₹ 100 each for the entire amount.
- (c) To issue equity capital for ₹ 25 lakhs (face value of ₹ 10) and 16% non-convertible debentures for the balance amount. In this case, the company can issue shares at a premium of ₹ 40 each.

Calculate the additional capital can be raised, keeping in mind that the management wants to maximise the earnings per share to maintain its goodwill. The company is paying income tax at 50%.

Answer

Calculation of Earnings per share under the three options:

Particulars	Options		
	Option I: Issue Equity shares only	Option II: Issue 16% Debentures only	Option III: Issue Equity Shares and 16% Deben of equal amount
Number of Equity Shares (nos):			
- Existing	10,00,000	10,00,000	10,00,000
- Newly issued	2,00,000	---	50,000
Total	12,00,000	10,00,000	10,50,000
16% Debentures ₹	---	50,00,000	25,00,000
	₹	₹	₹
Profit Before Interest and Tax:			
- Existing pre-tax profit	60,00,000	60,00,000	60,00,000
- From new projects	40,00,000	40,00,000	40,00,000
	1,00,00,000	1,00,00,000	1,00,00,000
Less: Interest on 16% Debentures	---	8,00,000 (16% ₹50,00,000)	4,00,000 (16% × ₹25,00,000)
Profit Before Tax	1,00,00,000	92,00,000	96,00,000
Tax at 50%	50,00,000	46,00,000	48,00,000
Profit After Tax	50,00,000	46,00,000	48,00,000
Earnings Per Share (EPS)	4.17	4.60	4.57

CAPITAL STRUCTURE

PAT	₹ 50,00,000	₹46,00,000	₹48,00,000
No. of Shares	<u>12,00,000</u>	<u>10,00,000</u>	<u>10,50,000</u>

Advise: Option II i.e. issue of 16% Debentures is most suitable to maximize the earnings per share.