Final exam of advanced finance

Finance

Study Guide for Final Exam

(TCO B) Which of the following statements concerning the MM extension with growth is NOT CORRECT? The tax shields should be discounted at the unlevered cost of equity. The value of a growing tax shield is greater than the value of a constant tax shield. For a given D/S, the levered cost of equity is greater than the levered cost of equity under MM's original (with tax) assumptions. For a given D/S, the WACC is greater than the WACC under MM's original (with tax) assumptions. The total value of the firm is independent of the amount of debt it uses. (Points: 20) (TCO D) Which of the following statements is most CORRECT? In a private placement, securities are sold to private (individual) investors rather than to institutions. Private placements occur most frequently with stocks, but bonds can also be sold in a private placement. Private placements are convenient for issuers, but the convenience is offset by higher flotation costs. The SEC requires that all private placements be handled by a registered investment banker. Private placements can generally bring in funds faster than is the case with public offerings. (Points: 20) (TCO E) Dakota Trucking Company (DTC) is evaluating a potential lease for a truck with a 4-year life that costs $40, 000 and falls into the MACRS 3-year class. If the firm borrows and buys the truck, the loan rate would be 10%, and the loan would be amortized over the truck's 4-year life. The loan payments would be made at the end of each year. The truck will be used for 4 years, at the end of which time it will be sold at an estimated residual value of $10, 000.

If DTC buys the truck, its after tax cash flows would be the following: (Year 1) - 6, 339; (Year 2) -4, 764; (Year 3)-9, 943; (Year 4) -5, 640; all occurring at the end of respective years. The lease terms, call for a $10, 000 lease payment (4 payments total) at the beginning of each year. DTC's tax rate is 40%. Should the firm lease or buy?

- (a) $849
- (b) $896
- (c) $945
- (d) $997
- (e) $1, 047 (Points: 20)

(TCO I) Suppose 90-day investments in Britain have a 6% annualized return and a 1. 5% quarterly (90-day) return. In the U. S. 90-day investments of similar risk have a 4% annualized return and a 1% quarterly (90-day) return. In the 90-day forward market, 1 British pound equals $1. 65. If interest rate parity holds, what is the spot exchange rate?

- 1 pound = $1. 8000
- 1 pound = $1. 6582
- 1 pound = $1. 0000
- 1 pound = $0. 8500
- 1 pound = $0. 6031 (Points: 20)

(TCO C) D. Paul Inc. forecasts a capital budget of $725, 000. The CFO wants to maintain a target capital structure of 45% debt and 55% equity, and it also wants to pay dividends of $500, 000.

If the company follows the residual dividend policy, how much income must it earn, and what will its dividend payout ratio be? Net Income Payout

- $898, 750 55. 63%
- $943, 688 58. 41%
- $990, 872 61. 43%
- $1, 040, 415 64. 40%
- $1, 092, 436 67. 62% (Points: 20)

(TCO F) Warren Corporation's stock sells for $42 per share. The company wants to sell some 20-year, annual interest, $1, 000 par value bonds. Each bond would have 75 warrants attached to it, each exercisable into one share of stock at an exercise price of $47.

The firm's straight bonds yield 10%. Each warrant is expected to have a market value of $2. 00 given that the stock sells for $42. What coupon interest rate must the company set on the bonds in order to sell the bonds-with-warrants at par?

- 7. 83%
- 8. 24%
- 8. 65%
- 9. 08%
- 9. 54% (Points: 20)

(TCO B) Which of the following statements is CORRECT, holding other things constant?

- Firms whose assets are relatively liquid tend to have relatively low bankruptcy costs, hence they tend to use relatively little debt.
- An increase in the personal tax rate is likely to increase the debt ratio of the average corporation.

- If changes in the bankruptcy code make bankruptcy less costly to corporations, then this would likely reduce the debt ratio of the average corporation.

An increase in the company's degree of operating leverage is likely to encourage a company to use more debt in its capital structure.

An increase in the corporate tax rate is likely to encourage a company to use more debt in its capital structure. (Points: 20)

TCO G) Chapter 7 of the Bankruptcy Act is designed to do which of the following?

- Protect shareholders against creditors.
- Establish the rules of reorganization for firms with projected cash flows that eventually will be sufficient to meet debt payments.
- Ensure that the firm is viable after emerging from bankruptcy.
- Allow the firm to negotiate with each creditor individually.

Provide safeguards against the withdrawal of assets by the owners of the bankrupt firm and allow insolvent debtors to discharge all of their obligations and to start over unhampered by a burden of prior debt. . (TCO I) Suppose one British pound can purchase 1. 82 U. S. dollars today in the foreign exchange market, and currency forecasters predict that the U. S. dollar will depreciate by 12. 0% against the pound over the next 30 days.

How many dollars will a pound buy in 30 days?

- 1. 12
- 1. 63
- 1. 82

- 2. 04
- 3. 64 (Points: 20)

(TCO H) Which of the following statements about valuing a firm using the APV approach is most CORRECT?

- The value of operations is calculated by discounting the horizon value, the tax shields, and the free cash flows at the cost of equity.
- The value of equity is calculated by discounting the horizon value, the tax shields, and the free cash flows at the cost of equity.
- The value of operations is calculated by discounting the horizon value, the tax shields, and the free cash flows before the horizon date at the unlevered cost of equity.
- The value of equity is calculated by discounting the horizon value and the free cash flows at the cost of equity.
- The APV approach stands for the accounting pre-valuation approach. (Points: 20)

(TCO A) Which of the following statements is CORRECT?

- Put options give investors the right to buy a stock at a certain strike price before a specified date.
- Call options give investors the right to sell a stock at a certain strike price before a specified date.
- Options typically sell for less than their exercise value.
- LEAPS are very short-term options that were created relatively recently and now trade in the market.

- An option holder is not entitled to receive dividends unless he or she exercises their option before the stock goes ex dividend. (Points: 20)

(TCO F) A swap is a method used to reduce financial risk.

Which of the following statements about swaps, if any, is NOT CORRECT?

- A swap involves the exchange of cash payment obligations.
- The earliest swaps were currency swaps, in which companies traded debt denominated in different currencies, say dollars and pounds.
- Swaps are very often arranged by a financial intermediary, who may or may not take the position of one of the counterparties.
- A problem with swaps is that no standardized contracts exist, which has prevented the development of a secondary market.
- A company can swap fixed interest payments for floating interest payments. (Points: 20)