

Keen

YOU HAVE 90 MINUTES TO COMPLETE BOTH PARTS OF THIS EXAM

Instructions:

1. The part of the exam is closed book and closed notes. No scrap paper is allowed; use the back of the exam if necessary. True/False questions are worth 2 points. Multiple-choice questions are worth 3 points. Short answer questions are worth 4 points unless otherwise noted.
2. Look over the entire exam before starting. The best strategy is generally to "cherry pick". In other words, solve the easiest (and/or most familiar) problems first. This will save time (and energy) that can be expended on the more difficult problems.
3. Partial points are based on readily observable evidence that you know at least part of the solution concept. The more evidence presented (and the clearer the evidence), the better the chance for partial points. In other words, **SHOW ALL WORK!**

1. "Maximize shareholders wealth" is the primary goal of shareholders. How can shareholders make "Maximize shareholders wealth" the primary goal of managers?

- abit themselves*
1. By designing us optimal contracts
 2. then minimize contracting costs
 - and keeping sharp look for moral hazard

(this maximize shareholder wealth)

2. Your company had a good year and will pay out either extra-large employee bonuses or one-time cash dividends to the stockholders. You are not a stockholder but are a bonus-earning employee. The CEO will herself get 5% of this year's employee bonus money. If paid, the extra dividends would be split equally among the 10 million shares of the firm's stock. The CEO owns 300,000 shares. What can we say about this situation?

3%

The CEO (circle correct answer) a. prefers the bonus b. prefers the dividend. c. has no preference.
You (circle correct answer) a. prefers the bonus b. prefers the dividend. c. has no preference.

3. (6 points) List the three components of an agency cost.

- a. Direct/Contracting
- b. Monitoring
- c. Misbehavior

4. Over the past 30 years, which of the following statements is most correct?

- a. In most years, firms will sell more common stock than preferred stock, and sell more preferred stock than debt.
- b. In most years, firms will sell more retained earnings stock than debt, and sell more debt than preferred stock.
- c. For the average firm's balance sheet, the reason that the common stock account is larger than the retained earnings account, is because retained earnings is a convertible security with a set redemption date while common stock has no redemption date.
- d. Even though about 90% of securities issued are bonds, the book value of bonds is typically smaller than the market value of preferred stock.
- e. All of the above statements are always false.

5. Preferred stock is a hybrid security that is often viewed a form of "expensive" debt.

- a. True
- b. False

6. List the four basic rights of shareholders.

- vote/control, preemptive
regulate Dividends, special liquidating Dividend

E

A

A 7. Which component of the gross underwriting spread is the largest?
A) the selling concession B) the underwriting fee
C) the management fee D) all of the above are about equal
E) none of the above

B 8. Under current U.S. Bankruptcy law, a firm can declare Chapter 11 any time the present value of the assets exceeds the present value of liabilities.
a. True b. False

BDO 9. Which of the following is most senior in terms of priority?
a. subordinated debt b. secured debt c. unsecured senior debt
d. unsecured claims created in the ordinary course of business

10. Your significant other is "cheating" on you. Would you prefer this be a moral hazard situation or a classic agency problem situation? Why did you answer as you did?

either answer, keeps who pays

C 11. A questionable motive two firms may have for merging include _____.
a. to achieve economies of scale in production, distribution, or another phase of their operations
b. to realize tax benefits c. to realize financial synergy
d. to get to surplus cash e. none of the above are questionable motives

A 12. Which (if any) of the following statements is false?
a. Holdouts are holders of outstanding securities who desire to exchange their securities for new ones.
b. The guiding principle of Chapter 11 reorganizations is that a debtor should be given the opportunity to negotiate with its creditors.
c. Chapter 11 offers a debtor the opportunity to freeze its debts while it attempts to negotiate a reorganization plan with creditors.
d. none of these

-1 -1
BCD 13. Which of the following is false?
a. A leveraged buyout (LBO) is an acquisition that is financed principally by borrowing.
b. For an LBO, the debt is secured by a lien on the firm's assets. X
c. Lenders look to the operating cash flow from assets to service the debt used to finance an LBO. ✓
d. LBOs are often used to take a firm public. X

E 14. Which of the following is false?
a. The basic premise of Chapter 11 is that debtors and creditors should negotiate to achieve a consensual plan of reorganization given the going-concern value of the reorganized debtor exceeds its liquidation value. true
b. The purpose of the cramdown provision is to facilitate the confirmation of a proposed plan when dissenting classes are refusing to accept a viable plan.
c. A prepackaged bankruptcy attempt is most likely to succeed when there is only one class of creditors that will be disadvantaged by the plan.
d. Holdouts are holders of outstanding securities who refuse to exchange their securities for new ones.
e. All of the above are true statements.

B 15. _____ permits the bankruptcy court to confirm a proposed plan over the objections of one or more classes of creditors.
a. Chandler's Method b. The cramdown procedure
c. The absolute priority doctrine d. none of these

Key

Exam I Spring 2009 FINC 4532 Your Name _____

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- 3) Look over the entire exam before starting. The best strategy is generally to "cherry pick". In other words, solve the easiest (and/or most familiar) problems first. This will save time (and energy) that can be expended on the more difficult problems.
- 4) Partial points are based on readily observable evidence that you know at least part of the solution concept. The more evidence presented (and the clearer the evidence), the better the chance for partial points. In other words, **SHOW ALL WORK!**
- 5) If you have additional time remaining, give your work one last check.

16. (4 points) You read the following headline, "Pill did not work, Pac-man was defeated, greenmail not an option," about a stock you own. Does this make you happy or sad? Explain your answer.

Happy, + take our defenses failed so firm will be taken over and you get more premium

1. (4 points) You are sole owner of the company. By year's end, your company has an equal chance of being worth either \$6 million or \$4 million. The company's debt is \$5 million and due at the end of the year. The company has a chance to invest in a project that will enhance its value. If the company chooses this project then by year's end it will have an equal chance of being worth either \$5.5 million or \$4.75 million. The project has a NPV of \$0.125 million. Do you accept the project? Explain your answer.

NO, classic under investment situation, the positive NPV goes to bond holders and reduces stock value

2. (4 points) Franny Lots is considering a loan for \$650,000 to GM Holdings. Laura estimates that she will incur \$15,000 in monitoring costs.

a. GM Holdings is promising to pay 9% annually on the loan. After paying monitoring costs, what annual percent return is Franny receiving?

$$9\% - \frac{15}{650} = 6.69\%$$

b. If a fair return on this loan is 8.9%, what is the minimum interest rate that Franny would require on this loan?

$$8.9\% + \frac{15}{650} = 11.2077\%$$

$$\text{Check } 72850 - 15000 = 57850$$

$$(650 \times 11.2\%)$$

$$\frac{57850}{650000} = 8.9\%$$

3. Carrollton Utilities currently has 5,000 shares with a market price of \$12.50 per share. They announce a rights offering of 1000 shares with a subscription price of \$10 per new share during the 16-day subscription period.

a. (2 points) How many rights will be needed to purchase a new share?

$$\frac{5000}{1000} = 5$$

b. (2 points) What is the market value of each right given this stock price?

$$\frac{S - P_r}{n + 1} = \frac{12.50 - 10}{6 + 1} = \$1.4167$$

c. (3 points) Assuming all of the rights are exercised, and no information was conveyed by the rights announcement, what is the expected stock price after the rights offering?

$$12.50 - 1.4167 = \$11.08$$

4. (3 points) Astral Telecom and Bright Wiring will merge. Astral has a total market value (VA) of \$90M (M = million), and Bright has a total market value (VB) of \$310M. Their merger will lead to operating efficiencies and will produce a synergistic effect of \$40. If the NAM is \$3, and expenses to complete the merger are \$4, what premium is being paid?

$$NAM = V_{AB} - V_A - V_B - E - P$$

$$3 = (90 + 310 + 40) - 90 - 310 - 4 - P \Rightarrow P = 33$$

5. Fill in the Blanks (15 points). The Peta Company acquires the Nofer company in a stock-for-stock deal.

	# Shares	P/E	EPS	Stock Price	NT	Value
Peta	25,000	12	\$1.19	① 14.28	② 29750	③ 357000
Nofer	100,000	19	\$1.30	① 29.70	② 130000	③ 2470000
Combined Company	177969.2	17.7	1.80694	14.28	159750	2827000

Key
impact

6. The firm you work for is trying to decide to file a Chapter 7 or a Chapter 11 bankruptcy. If it chooses to reorganize, the following future cash flows are expected: Year 1=\$24, Year 2=\$25, Year 3=\$36, Year 4=\$27, Year 5=\$38. The appropriate discount rate is 11%. The projected after-tax liquidation value of the firm's assets is \$150 if we liquidate the firm today. If we liquidate the firm in 5 years, the liquidation value is expected to be \$200.

a. (1 point for your answer, and 3 points for showing why your answer is correct.) Should we file Chapter 7 or Chapter 11?

We should file Chapter 11 because:

$$NPV(11\%, -150, \{24, 25, 36, 27, 38 + 200\})$$

+77.26 implies Ch 11 has higher value ∴ Ch 11

$$Ch 7 = 150 \quad Ch 11 = 150 + 77.26 = 227.26$$

7. (16.5 points, 1.5 points per blank, fill in all the blanks) Below is the Webegone Company's Balance Sheet. The firm is in Chapter 7 bankruptcy and is being liquidated. The firm's Trustee's are owed \$20. Given the below balance sheet, write out the amounts collected by each of the firm's creditors. All taxes and accrued wages have priority over secured debt. The Senior debt is secured by Fixed Assets. The Senior Secured has priority over Senior Subordinated. All other liabilities and equity have their normal claim order. The Debentures are subordinate to the Note Payable (Banks). An unusual aspect of this bankruptcy is that the operating divisions will be sold as "going concerns," with the acquirers' receiving only Fixed Assets. The bankrupt firm will retain all current assets, liabilities, and equity. These going concerns can be sold at an average price-to-sales ratio of 17%, based on the annual sales level of \$900. Current assets will then be liquidated at a market to book ratio of 60%.

		Amount Collected
CURRENT ASSETS	\$336	
NET FIXED ASSETS	554.0	
ACCOUNTS PAYABLE	\$145	<u>54</u>
NOTES PAYABLE (BANKS)	80	<u>29.79 + 33.52 = 63.31</u>
ACCRUED WAGES	14	<u>14</u>
FEDERAL TAXES	21	<u>21</u>
STATE/LOCAL TAXES	17	<u>17</u>
CURRENT LIABILITIES	\$239	
SENIOR SUBORDINATED	\$ 135	<u>102 + 12.29 = 114.29</u>
SENIOR SECURED	51	<u>51</u>
DEBENTURES	90	<u>33.52 - 33.52 = 0</u>
TOTAL LONG-TERM DEBT	\$ 276	
PREFERRED STOCK	\$ 8	<u>0</u>
COMMON STOCK	770	<u>0</u>
RETAINED EARNINGS	-403	<u>0</u>
TOTAL EQUITY	\$375	
TOTAL CLAIMS	\$890	

7.5
 .1111
 6
 4.5
 4.5
 .1111

336 x 60%

900 x 17%

TOTAL ASSETS \$890

~~Secured~~

Total	153	201.6	<u>354.6</u>	296.6
		-20. Trustee	<u>334.6</u>	-14 wages
		38. taxes	<u>296.6</u>	<u>282.6</u>
				-51
				<u>231.6</u>
				-102
				<u>129.6</u>

Unsecured	33 Sec'd	Secured
145 AP		153
80 NP		-51
90 Deb		<u>102</u>
348		-135
		<u>-33</u>
129.6	(37.29%)	
348		