

Key

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. There are 104 points on this exam; your score is limited to 100 points.
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? You need at least 2 sentences to get full credit for this question.

3-1. minimize contracting costs, align agents goals with principals
 1-2. have no moral hazards
 3 pts also pay bonus only = -3

2. (4 points) A company had a good year and will either extra-large employee bonuses or one-time cash dividends to the stockholders. 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. You are a stockholder but are not a bonus-earning employee. What can we say about this situation?

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. Preferred stock is a hybrid security that is the second most common form of internal financing.
 a. True b. False

4. Your significant other is "cheating" (act of lying, deception, fraud, trickery, imposture, or imposition) on you. Would you prefer this be a moral hazard situation or a classic agency problem situation? Why did you answer as you did? Note, your choice is irrelevant; all points are based on your explanation.

my favorite question

Key points - moral hazard I beg \$ costs but no psychic cost
 must recognize costs to get points
 a agency - she bears all costs, I may have psychic costs

5. A friend's significant other is "cheating" (act of lying, deception, fraud, trickery, imposture, or imposition) on your friend. Is this more likely to be a form of underinvestment problem or asset substitution? Why did you answer as you did? Note, your choice is irrelevant; all points are based on your explanation.

this most use specific friend blank

underinvestment implies ~~friend~~ other not investing is relationship
 asset sub implies you ~~friend~~ other is high risk, may also be replacing high with low risk both could be not cost either way
 cheating best
 also could answer as sig other
 key point is who bears cost, if agency, was not friend

6. 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 less 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 true.

A

7. List the four basic rights of shareholders.

voting, preemptive, regular Dividends, Liquidating Dividends

8. An investment banker earns lower fees on an underwritten stock offering than a rights offering.

- a. True
- b. False

B

9. Which of the following is not an advantage of going public?

- A) Going public enables a firm to raise additional capital.
- B) Going public gives existing shareholders a chance to sell portions of their shares as part of the IPO giving them a cash return on their investment and allows them to diversify their investment portfolios.
- C) Going public generally brings a lower price in the public market than in the venture capital or private placement markets.
- D) Going public achieves liquidity and diversification for current shareholders
- E) None of the above is an advantage of going public.

C

10. Under current U.S. Bankruptcy law, a firm can legally declare Chapter 7 at any time, regardless of how much is owed to creditors.

- a. True
- b. False

A

11. Which of the following is least senior in terms of bankruptcy "absolute priority"?

- a. preferred stock
- b. secured debt
- c. trustee fees
- d. unsecured claims created in the ordinary course of business
- e. All have equal priority; it depends on the decision of the bankruptcy judge.

A

12. A questionable motive two firms may have for merging included _____.

- 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

C

13. Which (if any) of the following statements is true?

- 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 fully repay the debts owed to creditors following an absolute priority rule.
- c. Chapter 7 offers a debtor the opportunity to freeze its debts while it attempts to negotiate a reorganization plan with creditors.
- d. All of the above statements are true.
- e. None of the above statements are true.

E

14. What is the best explanation for why companies have financial distress? Explain your answer.

poor management decisions
Bad capital budgeting, book explanations re
mostly symptoms of this.
Make decision - 3

Instructions:

- 1) The part of the exam is open book and open notes.
- 2) Point values are listed with the question.
- 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.

1. (4 points) Franny Lots is considering a loan for \$650,000 to GM Holdings. ~~Laura~~ ^{Franny} 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?

$$9 - \frac{15000}{650000} = 6.7\% \quad 6.67\%$$

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

$$8.9 + 2.3 = 11.2$$

2. 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?

5

$$\frac{5000}{1000}$$

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

\$.42

$$\frac{12.5 - 10}{5 + 1} = .416$$

c. Assume after the rights offering, the actual stock price is \$12.35. Did shareholders view the rights offering as good news or bad news (1 points)? Explain why you are correct (3 points).

Happy, expected price was 12.08 actual is 12.35.
good news

3. (4 points) You are sole owner of the company. By year's end, your company has an equal chance of being worth either \$6.00 million or \$4.50 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 \$6.25 million or \$4.00 million. The project has a negative NPV of \$0.25 million. Do you accept the project? Explain your answer.

Accept ~~Reject~~, ~~classic asset liability investment~~ ^{asset} / _{liab}
 Your payoff $\begin{matrix} \text{reject } .5 \times 6 \text{ or } 0 & -5 & .5 \\ \text{accept } .5 \times 6.25 \text{ or } 0 & & .625 \checkmark \end{matrix}$

4. (3 points) Astral Telecom will acquire Bright Wiring. Astral has a total market value (VA) of \$990M (M = million), and Bright has a total market value (VB) of \$310M. Assume the NAM is \$3, the expenses to complete the merger are \$4, and the premium being paid to Bright Wiring shareholders is \$30. Based on these numbers, what is the expected amount of operating efficiencies and synergistic effects?

$$3 = (990 + 310 + x) - 990 - 310 - 4 - 30$$

$$x = 37$$

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

upside
down myn's tie

	# Shares	P/E	EPS	Stock Price
Peta	25,000	15	\$1.19	17.85
Nofer	100,000	15	\$1.30	19.50
Combined Company	134293.7	15	1.19	17.85

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 \$100 if we liquidate the firm today. If we liquidate the firm in 5 years, the liquidation value is expected to be \$200. (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:

$$NPV \text{ of Ch 7} = 100$$

$$NPV \text{ of Ch 11} = (11, 0, \{ 24, 25, 36, 27, 38 + 200 \})$$

$$227.26$$

because $227.26 > 100$ by $|27.26$

37.69

7. (20.0 points, 2 points per blank, fill in all the blanks to get credit) Below is the Webe gone 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 for \$125. Current assets will then be liquidated at a market to book ratio of 30%.

					Amount Collected
CURRENT ASSETS	\$400		ACCOUNTS PAYABLE	\$45	<u>814</u>
NET FIXED ASSETS	528		NOTES PAYABLE (BANKS)	80	<u>16.28 + 14.47</u>
Gen	Fix	total	ACCRUED WAGES	14	<u>14</u>
120	125	245	FEDERAL TAXES	21	<u>21</u>
-20	151	<u>-20 Tr</u>	STATE/LOCAL TAXES	17	<u>17</u>
<u>-42</u>	<u>-26</u>	<u>-42</u>	CURRENT LIABILITIES		\$177
68			SENIOR SUBORDINATED	\$ 135	<u>24.42</u>
			SENIOR SECURED	151	<u>125 + 4.10</u> 129.70
			DEBENTURES	90	<u>0</u>
			TOTAL LONG-TERM DEBT	\$ 376	
			PREFERRED STOCK	\$ 8	<u>0</u>
			COMMON STOCK	770	<u>0</u>
			RETAINED EARNINGS	-403	<u>0</u>
			TOTAL EQUITY	\$375	
			TOTAL CLAIMS	\$928	
			TOTAL ASSETS	\$928	

26
135
90
80
45
376

$\frac{68}{376} = 18.09\%$