BEAM034 / BEMM689

UNIVERSITY OF EXETER

BUSINESS SCHOOL

May/ June 2009

CORPORATE FINANCE

Module Convenor: Claire Lavers

Duration: TWO HOURS

In Section A, you must answer ALL multiple choice questions - use the answer sheet provided.

In Section B, you must answer BOTH questions.

Only approved silent non-programmable calculators are permitted.

This is a closed note paper.

SECTION A

You must answer all 15 multiple choice questions – use the answer sheet provided.
Each question has only ONE correct answer (a, b, c, d or e). Each question is worth 3 points.

Questions

1 When an entire security issue is directly sold to institutional investors, it is called

(a) a public issue
(b) a private placement
(c) an initial public offering
(d) an introduction
(e) none of the above

2 Firm A has a value of $100 million, and B has a value of $60 million. Merging the two would allow a cost savings with a present value of $20 million. Firm A purchases B for $65 million. How much do firm A's shareholders gain from this merger?

(a) $30 million
(b) $20 million
(c) $15 million
(d) $5 million
(e) None of the above

3 What would to be the required rate of return for equity investors if a share sells for £40 and will pay a £4.40 dividend that is expected to grow at a constant rate of 5%?

(a) 7.6%
(b) 12.0%
(c) 12.6%
(d) 16.0%
(e) None of the above

4 Firms facing financial distress may pass up positive NPV projects rather than commit new equity because:

(a) they prefer to finance with debt.
(b) the benefits may be shared with the bondholders.
(c) no cash is available for dividends.
(d) there is no interest tax shield associated with equity.
(e) None of the above

5

	AAA	AA	A	BBB
AAA	0.9050	0.0859	0.0074	0.0006
AA	0.0076	0.9074	0.0762	0.0064
A	0.0009	0.0262	0.9069	0.0547
BBB	0.0003	0.0027	0.0615	0.8653
BB	0.0003	0.0016	0.0070	0.0738
B	0.0000	0.0008	0.0034	0.0053
CCC	0.0015	0.0000	0.0046	0.0109
D	0.0000	0.0000	0.0000	0.0000
E	0.0000	0.0000	0.0000	0.0000

According to the two period transition matrix above, what are the probabilities of
(i) a bond rated AAA today being rated AA in the next period
(ii) a bond rated BBB being rated AAA in the next period

(a) 0.0859 and 0.0003
(b) 0.9050 and 0.0003
(c) 0.9050 and 0.8653
(d) 0.0859 and 0.8653
(e) 0.0859 and 0.0006

6 The Indirect costs of bankruptcy are borne principally by:

(a) Bondholders
(b) Shareholders
(c) Managers
(d) The national government
(e) None of the above

7 What is the return on equity for a firm with 15% WACC, a 10% return on debt, and a 0.75 debt/equity ratio?

(a) 18.75%
(b) 19.00%
(c) 20.00%
(d) 23.75%
(e) 26.25%

Turn over/…

8 When new securities are sold by a firm, it is called

(a) Primary market transaction
(b) Secondary market transaction
(c) O-T-C market transaction
(d) A seasoned equity offering
(e) None of the above

9 If a defined benefit plan has pension assets of $150 million and a pension liability of $140 million, then which of the following is true:

(a) The plan has a surplus of $10 million
(b) The plan has a surplus of $110 million
(c) The plan has a deficit of $10 million
(d) The plan has a deficit of $110 million
(e) None of the above

10 An example of a pension scheme where current contributions are paid to current pensioners is

(i) A public (social security) pension
(ii) A defined benefit pension
(iii) A personal pension

(a) i only
(b) ii only
(c) iii only
(d) i and ii only
(e) ii and iii only

11 Which of the following are <u>not</u> indirect costs of financial distress?

(a) Impaired ability to do business
(b) Selling assets at lower than market value
(c) Loss of human capital
(d) Administrative costs
(e) Agency costs

12 Mergers and Acquisitions in the same industry and at the same stage of the supply chain are called:

(a) Leveraged buyouts
(b) Horizontal mergers
(c) Vertical mergers
(d) Conglomerate mergers
(e) None of the above

13 Which of the following is considered a bad justification for a merger from the perspective of the companies' shareholders?

(a) Synergy theory
(b) Undervaluation theory
(c) Diversification theory
(d) Market power theory
(e) None of the above

14 Altman's Z-score is used to:

(a) Evaluated the managerial efficiency of a firm
(b) Measure of under-pricing in Initial Public Offerings (IPOs)
(c) Distinguish between firms that will, and will not, become bankrupt
(d) All of the above
(e) None of the above

15 An decrease in the probability of default increases the:

(a) promised yield
(b) expected yield
(c) coupon rate
(d) contributions to the PBGC
(e) none of the above

Turn over/…

SECTION B

You must answer both questions in this section. Clearly explain all your steps and assumptions.

Question 1

(a) Define the following, and identify any data and theoretical problems involved in calculating, or estimating, each of them

(i) the beta of equity
(ii) the risk free rate
(iii) the risk premium
(iv) the cost of debt

(12 marks)

(b) Outline the uses of the weighted average cost of capital (WACC).

(4 marks)

(c) Explain how errors in estimating the variables in part (a) above, would affect the usefulness of the WACC.

(4 marks)

Question 2

Flutey Plc has issued a 6% bond with a face value of £100 maturing in one year. Assume that the risk free interest rate is 6%.

Calculate (a) the promised yield and (b) the expected yield, if

(i) There is no possibility of default.

(6 marks)

(ii) There is a 60% chance of default, in which case Flutey Plc will pay the coupon plus 41% of the face value. Assume that, when there is a probability of default, the market price of the bond will be £66.60.

(12 marks)

(c) Explain the differences between the promised yields and expected yields you calculated in parts (i) and (ii) above.

(3 marks)

(d) Why does the market price of this bond change when the probability of default becomes higher than zero?

(3 marks)

(e) If we were to calculate the default adjusted yield, of a bond with a maturity of more than one year, describe what additional factors we would have to incorporate into our calculations.

(11 marks)

End of paper