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# Question 1

**Question Type:** MultipleChoice

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| | X-Sport Inc. | | | | | Industry Average |
|---|---|---|---|---|---|---|
| | *Current* | *Plan A* | *Plan B* | *Plan C* | *Plan D* | |
| Debt/equity | 1.50 | 2.33 | 1.86 | 1.22 | 0.82 | 1.27 |
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| Expected EPS | $5.67 | $6.00 | $6.33 | $5.47 | $4.89 | $6.31 |
| Payout ratio | 45% | | | | | 42% |
| Growth rate | 6.1% | | | | | 5.9% |
| Stock price | $43 | | | | | |

After carefully analyzing the data, Kelley writes his analysis and proposal and submits the report to Richard Haywood, the chairman and CEO of X-Sport Inc. Excerpts from the analysis and proposal follow:

* In selecting a re-financing plan, we must not push our leverage ratio too high. An overly aggressive leverage ratio will likely cause debt rating agencies to downgrade our debt rating from its current Baa rating, causing our cost of debt to rise dramatically. This effect is explained using the static trade-off capital structure theory, which states that if our debt usage becomes high enough, the marginal increase in the interest tax shield will be more than The marginal increase in the costs of financial distress. However, using some additional leverage will benefit the company by reducing the net agency costs of equity required to align the interests of X-Sport management with its shareholders.

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Haywood reviews the report and calls Kelley into his office to discuss the proposal. Haywood suggests that Flan B would be the most appropriate choice for adjusting X-Sport's capital structure. Before Kelley can argue, however, the two are interrupted by a previously scheduled meeting with a supplier.

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A group of shareholders, upset about the board's plan, submit a formal objection to X-Sport's board as well as to the SEC. In the objection, the shareholders state that the independence of the board has been compromised to the detriment of the company and its shareholders. The objection also states that:

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* The asset risk of X-Sport has increased due to the inability of investors to trust the GearTech financial disclosures necessary to value the division.

Evaluate the three statements in the shareholders' formal objection submitted to X-Sport's board of directors. The objection is correct with regard to;

## Options:

**A-** asset risk.

**B-** liability risk.

**C-** the value impact.

## Answer:

C

## Explanation:

X-Sports board of directors suffers from a lack of independence from management. The most pressing issue is that the CEO of the company, Richard Haywood, is also the chairman of the board. Judging by his ability to convince the board of his plan ro spin off GearTech, Haywood exerts an excessive degree of influence over the board. This lack of independence could negatively impact the value of X-Sport common stock as investors will demand a higher risk premium for holding the stock since there is a significant risk that management will not act in the shareholders1 best interest. Specifically, there is a great risk (as evidenced by their quick decision to spin off GearTech) that management will enter into future transactions (such as mergers, acquisitions, and divestitures) and assume business risks that are in management's interest but not in the shareholders* best interest. This is known as strategic policy risk, not liability risk. Note that there are two former executives of GearTech on the board who may benefit from spinning off the company. It is

possible that the poor corporate governance at X-Sport may call into question the reliability of the financial disclosures of GearTech, but this risk is known as accounting risk, not asset risk. (Study Session 9, LOS 30.f,g)

# Question 2

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Which of the following statements with regard to the alternative plans proposed to X-Sport's board of directors by Haywood is correct?

## Options:

**A-** The GearTech plan is an example of a spin-off transaction, while the Euro-Sport plan is an example of a carve-out transaction.

**B-** The GearTech plan is an example of a carve-out transaction, while the Euro-Sport plan is an example of a spin-off transaction.

**C-** Both the GearTech plan and the Euro-Sport plans arc examples of spin-off transactions.

## Answer:

A

## Explanation:

Spin-off transactions involve creating a new entity out of a company's business line or one of its subsidiaries and then granting shares in the new entity to the existing shareholders of the parent company. The shareholders are then free to sell their shares in the spin-off company in the marketplace. Spin-offs are generally viewed as a favorable sign in the market since they often result in greater efficiency for the spin-off company and the parent company. In a carve-out transaction, a new entity is created in a similar manner to the spin-off transaction. The main difference is that a minority of shares is sold to the public while the majority portion of the new shares are held by the parent company (they are not distributed to existing shareholders). (Study Session 9, LOS 31.o)

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Estimate the approximate stock price that X-Sport could expect if the company proceeds with Plan D as suggested in Kclley's report.

## Options:

**A-** $46.

**B-** $53.

**C-** $56.

## Answer:

A

## Explanation:

To answer this question, we must first calculate the expected dividend payout for Plan D: D, = 4.89 x 0.45 = 2.20. The stock price under any of the plans can be estimated using the constant growth dividend discount model since the growth rate is given as 6.1%. For Plan D, the estimated stock price would be:

$$\frac{D_1}{K_e - g} = \frac{2.20}{(0.109 - 0.061)} = \$45.83 \approx \$46$$

(Study Session 8, LOS 28.i)

# Question 4

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Which of the following best explains the difference between X-Sport's current cost of debt and the cost of debt associated with Plan A?

## Options:

**A-** Decreased tax advantage with Plan A.

**B-** Increased liquidity risk for Plan A bond purchasers.

**C-** Increased probability of bankruptcy with Plan A.

## Answer:

C

## Explanation:

The most likely difference in the cost of debt financing between the current level of 5-0% and the 8.5% for Plan A is that there is a greater probability of bankruptcy. Using the debt-to-equity ratio we observe that Plan A calls for 2.33 / (2.33 + I) = 70% debt financing, which is a very large proportion of the capital structure. The chances of bankruptcy are much greater with this heavy reliance on debt financing. (Study Session 8, LOS 28.f)

# Question 5

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Determine whether Kelley's report is correct with regard to the statements made about the static trade-off theory of capital structure and the net agency costs of equity.

## Options:

**A-** Kelley is only correct with respect to the static trade-off theory.

**B-** Kelley is only correct with respect to the net agency cost of equity.

**C-** Kelley is incorrect with respect to the static trade-off theory and the net agency cost of equity.

## Answer:

B

### Explanation:

Kelleys report is incorrect regarding the static trade-off theory of capital structure, which states that a company should lever up to the point at which the additional increase in the costs of financial distress exceeds the additional increase in the tax shield from interest rate payments. Once this point is reached, adding more leverage to the company will decrease its value. Kelleys report is correct regarding the net agency costs of equity. Agency costs include equity holders' cost to monitor the firm's executives, managements bonding costs to assure owners that their best interests arc guiding the company's actions, and residual losses that result even when sufficient monitoring and bonding exists. Adding additional debt reduces the agency costs to equity holders since less of their capital is at risk. The leverage effectively shifts some of the agency costs to bondholders. Additionally, managers have less cash to squander when higher leverage is employed since higher interest costs will restrict discretionary free cash flow. (Study Session 8, LOS 28-0)

# Question 6

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Using the information in Exhibit 1, calculate X-Sport's weighted average cost of capital for the optimal capital structure.

## Options:

**A-** 7.46%.

**B-** 7.75%.

**C-** 8.76%.

## Answer:

A

## Explanation:

Begin by calculating the capital structure of each plan and then multiply the percentage of debt and equity by their component costs and add the results to find the weighted average cost of capital (WACC). The plan with the lowest WACC maximizes the firms stock price and thus reflects the optimal capital structure. In this case, Plan C meets all of the criteria for optimizing X-Sport's capital structure. Plan C's debt to equity ratio is 1.22. Thus, there are 1.22 units of debt for every one unit of equity for a total of 2.22 units of capital. Therefore, the percentage debt is 1.22 / 2.22 = 55%, leaving 45% equity. Thus', the WACC for Plan C is: (0.55 x 4.4%) + (0.45 x 11.2%) = 7.46%.

Repeating these calculations for Plans A, B, and D, we find that the WACCs arc 10.75%, 8.76%, and 7.75%, respectively. (Study Session 8, LOS 28.g)

# Question 7

**Question Type:** **MultipleChoice**

Fashion Inc. is a major U .S . distributor of high quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the Chief Executive Officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relics on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage

companies.

**Exhibit 1: Financial and Market Data for Fashion, Inc. and Flavoring International**

| *Financial/Price Data* | *Fashion* | *Flavoring* |
|---|---|---|
| Sales | $400 million | $105 million |
| Net income | $80 million | $22 million |
| Cash Flow | $140 million | $42 million |
| Book Value | $320 million | $72 million |
| Number of common shares outstanding | 50 million | 20 million |
| Current market price of common stock | $30.50 | $20.00 |
| Recent market price range | $34–26 | $22–18 |

**Exhibit 2: Transaction Data for Food and Beverage Industry**

| *Valuation Variables* | *Jones Foods* | *Dale Inc.* | *Hill Brands* | *Lane Co.* | *Mean Multiple* |
|---|---|---|---|---|---|
| Acquisition stock price | $24 | $32 | $40 | $46 | — |
| Price/Sales per share | 5.0 | 3.7 | 4.0 | 3.8 | 4.13 |
| Price/Book Value per share | 6.9 | 5.5 | 5.8 | 5.6 | 5.95 |
| Price/Earnings per share | 20.0 | 22.1 | 18.0 | 19.0 | 19.78 |
| Price/Cash Flow per share | 11.8 | 13.0 | 10.5 | 11.0 | 11.58 |

To justify his use of the comparable transaction approach to establish a fair acquisition for Flavoring, Smith would like to conclude his report with the most important reason for choosing this approach. Which of the following rationales would Smith most likely use?

## Options:

**A-** The fair acquisition price developed for Flavoring reflects a market based valuation approach, an advantage compared to discounted cash flow valuations, which are based on assumptions that do not incorporate market valuations.

**B-** The acquisition prices for recently acquired companies provide a reasonable approximation of their realistic intrinsic values.

**C-** The fair acquisition price developed for Flavoring is a realistic estimate of potential value to Fashion given that forecasts of future performance are unavailable.

## Answer:

A

## Explanation:

This is a key reason to use the comparable value method, particularly when contrasted with the use of discounted cash flow valuations. Acquisition prices are not necessarily approximations of intrinsic values. A price developed based on comparable transactions does not always indicate the potential value of the acquisition to the purchaser. (Study Session 9, LOS 31.i)

# Question 8

**Question Type:** **MultipleChoice**

Fashion Inc. is a major U .S . distributor of high quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the Chief Executive Officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

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| Price/Cash Flow per share | 11.8 | 13.0 | 10.5 | 11.0 | 11.58 |

Based on pre-acquisition prices of $20 for Jones Foods, $26 for Dale Inc., S35 for Hill Brands, and $40 for Lane Co., the mean takeover premium for Flavoring would be closest to;

## Options:

**A-** 12.50%.

**B-** 15.25%.

**C-** 18.10%.

## Answer:

C

## Explanation:

The takeover premium can be based on various statistics (mean, median, mode) of takeover premiums observed for comparable companies. In this case the takeover premium is based on equally weighting the takeover premium for the four recently acquired companies.

| | Jones Foods | Dale Inc. | Hill Brands | Lane Co. | Mean |
|---|---|---|---|---|---|
| Pre-acquisition price (A) | $20 | $26 | $35 | $40 | — |
| Acquisition price (B) | $24 | $32 | $40 | $46 | — |
| Takeover premium = (B – A) / A | 20.0% | 23.1% | 14.3% | 15.0% | 18.1% |

(Study Session 9, LOS 31.k)

## Question 9

**Question Type:** MultipleChoice

Fashion Inc. is a major U .S . distributor of high quality women's jewelry and accessories. The company's growth in recent years has been moderately above the industry average. However, competition is intensifying as a number of overseas competitors have entered this mature market. Although Fashion has been a publicly held company for many years, members of senior management and their families control 20% of the outstanding common stock. Martin Silver, the Chief Executive Officer, has been under intense pressure from both internal and external large shareholders to find ways to increase the company's future growth.

Silver has consulted with the company's investment bankers concerning possible merger targets. The most promising merger target is Flavoring International, a distributor of a broad line of gourmet spices in the United States and numerous other countries. In recent

years, Flavoring's earnings growth rate has been above competitors' and also has exceeded Fashion's experience. Superior income growth is projected to continue over at least the next five years. Silver is impressed with the appeal of the company's products to upscale customers, its strong operating and financial performance, and Flavoring's dynamic management team. He is contemplating retirement in three years and believes that Flavoring's younger, more aggressive senior managers could boost the combined company's growth through increasing Fashion's operating efficiency and expanding Fashion's product line in countries outside the United States. Alan Smith, who is Silver's key contact at the investment banking firm, indicates that a key appeal of this merger to Flavoring would be Fashion's greater financial flexibility and access to lower cost sources of financing for expansion of its products in new geographic areas. Fashion has a very attractive performance based stock option plan. Flavoring's incentive plan is entirely based on cash compensation for achieving performance goals. Additionally, the 80% of Fashion's stock not controlled by management interests is very widely held and trades actively. Flavoring became a publicly held company three years ago and doesn't trade as actively.

Silver has asked Smith to prepare a report summarizing key points favoring the acquisition and an acceptable acquisition price. In preparing his report, Smith relics on the following financial data on Fashion, Flavoring, and four recently acquired food and beverage companies.

**Exhibit 1: Financial and Market Data for Fashion, Inc. and Flavoring International**

| *Financial/Price Data* | *Fashion* | *Flavoring* |
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**Exhibit 2: Transaction Data for Food and Beverage Industry**

| *Valuation Variables* | *Jones Foods* | *Dale Inc.* | *Hill Brands* | *Lane Co.* | *Mean Multiple* |
|---|---|---|---|---|---|
| Acquisition stock price | $24 | $32 | $40 | $46 | — |
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| Price/Book Value per share | 6.9 | 5.5 | 5.8 | 5.6 | 5.95 |
| Price/Earnings per share | 20.0 | 22.1 | 18.0 | 19.0 | 19.78 |
| Price/Cash Flow per share | 11.8 | 13.0 | 10.5 | 11.0 | 11.58 |

Using the comparable transaction approach based on the four recently acquired companies, Smith determines an estimated takeover value based on equally weighted key valuation variables. The estimated takeover value would be closest to;

## Options:

**A-** $20.27.

**B-** $21.76.

**C-** $22.30.

## Answer:

C

## Explanation:

The following statistics show calculations of estimated takeover value using equal weighting.

| *Estimated Takeover Value* | *Flavoring* | *Mean Multiple* | *Price/Share* | *Equal Weight* | *Est. Value* |
|---|---|---|---|---|---|
| Sales per share | $5.25 | 4.13 | $21.68 | 0.25 | $5.42 |
| Book value per share | $3.60 | 5.95 | $21.42 | 0.25 | $5.36 |
| Earnings per share | $1.10 | 19.78 | $21.76 | 0.25 | $5.44 |
| Cash flow per share | $2.10 | 11.58 | $24.32 | 0.25 | $6.08 |
| Total estimated value | | | | | $22.30 |

(Study Session 9, LOS 31.k)

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