Final Term Papers

Spring 2009 (Session 02)

MGT201

(Group is not responsible for any solved content)

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Question No: 1 (Marks: 1) - Please choose one

What is the long-run objective of financial management?

- ► Maximize earnings per share
- ► **Maximize the value of the firm's common stock**
- ► Maximize return on investment
- ► Maximize market share

Question No: 2 (Marks: 1) - Please choose one

Which of the following statement (in general) is correct?

- ► A low receivables turnover is desirable
- ► **The lower the total debt-to-equity ratio, the lower the financial risk for a firm**
- ► An increase in net profit margin with no change in sales or assets means a weaker ROI
- ► The higher the tax rate for a firm, the lower the interest coverage ratio

Question No: 3 (Marks: 1) - Please choose one

What is the present value of a Rs.1,000 ordinary annuity that earns 8% annually for an infinite number of periods?

- ► Rs.80
- ► Rs.800
- ► Rs.1,000
- ► **Rs.12,500**

It will be treated as perpetuity, Formula is as under:
PV= PMT/i
= 1000/.08
= 12,500

Question No: 4 (Marks: 1) - Please choose one

Companies and individuals running different types of businesses have to make the choices of the asset according to which of the following?

- ► Life span of the project
- ► Validity of the project

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- Cost of the capital
- **Return on asset**

Question No: 5 (Marks: 1) - Please choose one

What is the advantage of a longer life of the asset?

- Cash flows from the asset becomes non-predictable
- **Cash flows from the asset becomes more predictable**
- Cash inflows from the asset becomes more predictable
- Cash outflows from the asset becomes more predictable

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Question No: 6 (Marks: 1) - Please choose one

Consider two bonds, A and B. Both bonds presently are selling at their par value of Rs. 1,000. Each pays interest of Rs. 120 annually. Bond A will mature in 5 years while bond B will mature in 6 years. If the yields to maturity on the two bonds change from 12% to 10%, _____.

- Both bonds will increase in value, but bond A will increase more than bond B
- Both bonds will increase in value, but bond B will increase more than bond A
- Both bonds will decrease in value, but bond A will decrease more than bond B
- **Both bonds will decrease in value, but bond B will decrease more than bond A**

Question No: 7 (Marks: 1) - Please choose one

Given no change in required returns, the price of a stock whose dividend is constant will_____.

- **Remain unchanged**
- Decrease over time at a rate of r%
- Increase over time at a rate of r%
- Decrease over time at a rate equal to the dividend growth rate

Question No: 8 (Marks: 1) - Please choose one

For most firms, P/E ratios and risk_____.

- Will be directly related

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► **Will have an inverse relationship**
► Will be unrelated
► Will both increase as inflation increases

Question No: 9 (Marks: 1) - Please choose one

Which of the following statement about portfolio statistics is CORRECT?

► **A portfolio's expected return is a simple weighted average of expected returns of the individual securities comprising the portfolio.**
► A portfolio's standard deviation of return is a simple weighted average of individual security return standard deviations.
► The square root of a portfolio's standard deviation of return equals its variance.
► The square root of a portfolio's standard deviation of return equals its coefficient of variation.

Question No: 10 (Marks: 1) - Please choose one

Which of the following is simply the weighted average of the possible returns, with the weights being the probabilities of occurrence?

► A probability distribution
► **The expected return**
► The standard deviation
► Coefficient of variation

Question No: 11 (Marks: 1) - Please choose one

The square of the standard deviation is known as the _____.

► Beta
► Expected return
► Coefficient of variation
► **Variance**

Reference

Question No: 12 (Marks: 1) - Please choose one

Why companies invest in projects with negative NPV?

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- **Because there is hidden value in each project**
- Because they have chance of rapid growth
- Because they have invested a lot
- All of the given options

Question No: 13 (Marks: 1) - Please choose one

An investor was expecting a 18% return on his portfolio with beta of 1.25 before the market risk premium increased from 8% to 10%. Based on this change, what return will now be expected on the portfolio?

- 22.5%
- 20.0%
- **20.5%**
- 26.0%

Working: 2% rise in market risk premium rise in expected return will be 2*beta = (2*1.25 = 2.50)
18%+2.50 = 20.5

Question No: 14 (Marks: 1) - Please choose one

Which of the following is the characteristic of a well diversified portfolio?

- Its market risk is negligible
- **Its unsystematic risk is negligible**
- Its systematic risk is negligible
- All of the given options

Question No: 15 (Marks: 1) - Please choose one

How the beta of a stock can be calculated?

- By monitoring price of the stock
- By monitoring rate of return of the stock
- **By comparing the changes in the stock market price to the changes in the stock market index**
- All of the given options

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Question No: 16 (Marks: 1) - Please choose one

Which of the following formula relates beta of the stock to the standard deviation?

- ► Covariance of stock with market * variance of the market
- ► **Covariance of stock with market / variance of the market**
- ► Variance of the market / Covariance of stock with market
- ► Slope of the regression line

Beta = Covariance (stock versus market returns) / Variance of the Stock Market
http://www.money-zine.com/Investing/Stocks/Stock-Beta-and-Volatility/

Question No: 17 (Marks: 1) - Please choose one

A beta greater than 1 for a stock shows:

- ► Stock is relatively more risky than the market
- ► If the market moves up by 10% the stock will move up by 12%
- ► As the market moves the stock will move in the same direction
- ► **All of the given options**

Question No: 18 (Marks: 1) - Please choose one

If stock is a part of totally diversified portfolio then its company risk must be equal to:

- ► **0**
- ► 0.5
- ► 1
- ► -1

Question No: 19 (Marks: 1) - Please choose one

If risk and return combination of any stock is above the SML, what does it mean?

- ► It is offering lower rate of return as compared to the efficient stock
- ► **It is offering higher rate of return as compared to the efficient stock**
- ► Its rate of return is zero as compared to the efficient stock
- ► It is offering rate of return equal to the efficient stock

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Any Stock whose (Risk, Return) Pair lies ABOVE THE SML is offering Excessive Return (above the Market). So, all rational investors will rush to Buy it. The present Price would Rise and the Return (as measured by Capital Gain Yield = (Pn -Po) / Po) would Fall until it comes back on SML Any Stock whose (Risk, Return) Pair lies BELOW THE SML is offering a Return that is lower than the Market. So, Rational Investors will rush to sell it. The Stock Price would Fall and the Return would Rise until it comes back on the SML.

Question No: 20 (Marks: 1) - Please choose one

An arbitrage opportunity exists if an investor can construct a _____ investment portfolio that will yield a sure profit.

- ► Positive
- ► Negative
- ► **Zero**
- ► All of the given options

If the investor can construct a portfolio without the use of the investor's own funds and the portfolio yields a positive profit, arbitrage opportunities exist.

Question No: 21 (Marks: 1) - Please choose one

Which of the following factors might affect stock returns?

- ► The business cycle
- ► Interest rate fluctuations
- ► Inflation rates
- ► **All of the given options**

Question No: 22 (Marks: 1) - Please choose one

If arbitrage opportunities are to be ruled out, what would be the expected excess return of each well-diversified portfolio?

- ► Inversely proportional to the risk-free rate
- ► Inversely proportional to its standard deviation
- ► Proportional to its standard deviation
- ► **Proportional to its beta coefficient**

Rationale: For each well-diversified portfolio (P and Q, for example), it must be true that $[E(r_p)-r_f]/\beta_p = [E(r_Q)-r_f]/\beta_Q$.

Question No: 23 (Marks: 1) - Please choose one

Which of the following represent all Risk –Return Combinations for the efficient portfolios in the capital market?

- ► Parachute graph
- ► **CML straight line equation**
- ► Security market line
- ► All of the given options

The CML gives the risk/return relationship for efficient portfolios.

Question No: 24 (Marks: 1) - Please choose one

What should be used to calculate the proportional amount of equity financing employed by a firm?

- ► The common stock equity account on the firm's balance sheet
- ► The sum of common stock and preferred stock on the balance sheet
- ► The book value of the firm
- ► **The current market price per share of common stock times the number of shares Outstanding**

http://web.utk.edu/~jwachowi/mcquiz/mc15.html

Question No: 25 (Marks: 1) - Please choose one

Which of the following is the market for short term debt?

- ► **Money market**
- ► Capital market
- ► Real asset market
- ► Equity market

Question No: 26 (Marks: 1) - Please choose one

Bonds are issued in the market at _____.

- ► Premium

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- Discount
- **Both premium and discount**
- None of the given options

Question No: 27 (Marks: 1) - Please choose one

Why debt is a less costly source of fund?

- **Because additional interest creates a new form of tax shield**
- Because additional money creates a new form of tax shield
- Because banks extend loan at lower interest rates
- None of the given options

Question No: 28 (Marks: 1) - Please choose one

Which of the following is as EBIT?

- Funds provided by operations
- Earnings before taxes
- Net income
- **Operating profit**

Question No: 29 (Marks: 1) - Please choose one

Calculate the degree of operating leverage (DOL) at 400,000 units of quantity sold. The firm has Rs.1, 000,000 in fixed costs. The firm anticipates selling each unit for Rs.25 with variable costs of Rs.5 per unit.

- 3.33
- 1.25
- **1.14**
- There is not sufficient information provided to calculate the degree of operating leverage (DOL).

Sales = 400,000 * 25 = 10M

VC = 400,000 * 5 = 2M

The DOL is (S - VC)/(S - VC - FC) = (10M - 2M)/(10M - 2M - 1M) = 1.14

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Question No: 30 (Marks: 1) - Please choose one

A firm has a DOL of 3.5 at Q units. What does this tell us about the firm?

- ► If sales rise by 3.5% at the firm, then EBIT will rise by 1%
- ► If EBIT rises by 3.5% at the firm, then EPS will rise by 1%
- ► If EBIT rises by 1% at the firm, then EPS will rise by 3.5%
- ► **If sales rise by 1% at the firm, then EBIT will rise by 3.5%**

Question No: 31 (Marks: 1) - Please choose one

Which of the following represents financial leverage?

- ► **Use of more debt capital to increase profit**
- ► Debt is not used in capital to increase profit
- ► High degree of solvency
- ► Low degree of solvency

Question No: 32 (Marks: 1) - Please choose one

Which of the following best describes the statement; "The value of an asset is preserved regardless of the nature of the claims against it"?

- ► Law of diminishing marginal returns
- ► **Law of conservation of value**
- ► Law of return on equity
- ► Law of return on assets

Reference

Question No: 33 (Marks: 1) - Please choose one

Firm ABC has Rs.5 million in outstanding debt, currently has 200,000 shares outstanding priced at Rs.60 a share, and has a borrowing rate of 10%. If the firm's return on equity is 15%, what is the firm's WACC?

- ► 5.00%
- ► **3.23%**
- ► 4.25%
- ► 2.16%

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Note: we are not sure about answer of this Question it seems options are not framed properly. We try to solve it here

In absence of Tax Rate. Values are as follow

D = 5M

E = 200,000 *60 = 12 M

D+ E = 5+12= 17M

WCCA = (5/17)*(10%) + (12/17)*(15%) = .1350 = 13.50%

Question No: 34 (Marks: 1) - Please choose one

Which of the following statements regarding the M&M Propositions without taxes is true?

► The total value of the firm depends on how cash flows are divided up between stockholders and bondholders, under M&M Proposition I.

► The firm's capital structure is relevant under M&M Proposition I.

► The cost of equity depends on the firm's business risk but not its financial risk, under M&M Proposition II.

► **The cost of equity rises as the firm increases its use of debt financing under M&M Proposition II.**

Question No: 35 (Marks: 1) - Please choose one

Which one of the following is correct for the spot exchange rate?

► **This is the rate today for exchanging one currency for another for immediate delivery**

► This is the rate today for exchanging one currency for another at a specific future date

► This is the rate today for exchanging one currency for another at a specific location on a specific future date

► This is the rate today for exchanging one currency for another at a specific location for immediate delivery

The rate of a foreign-exchange contract for immediate delivery. Also known as "benchmark rates", "straightforward rates" or "outright rates", spot rates represent the price that a buyer expects to pay for a foreign currency in another currency.

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Question No: 36 (Marks: 1) - Please choose one

The restructuring of a firm should be undertaken, when:

- ► **The restructuring is expected to create value for shareholders**
- ► The restructuring is expected to increase earnings per share next year
- ► The restructuring is expected to increase the firm's market share power in industry
- ► The current employees will receive additional stock options to align employee interest

Question No: 37 (Marks: 1) - Please choose one

Which of the following term is used when the firm can independently control considerable assets with a very limited amount of equity?

- ► Joint venture
- ► **Leveraged buyout (LBO)**
- ► Spin-off
- ► Consolidation

The acquisition of another company using a significant amount of borrowed money (bonds or loans) to meet the cost of acquisition. Often, the assets of the company being acquired are used as collateral for the loans in addition to the assets of the acquiring company. The purpose of leveraged buyouts is to allow companies to make large acquisitions without having to commit a lot of capital.

Question No: 38 (Marks: 1) - Please choose one

What is the economic order quantity for an automobile dealer selling 2,000 cars per year, at a cost of Rs.750 per order, and a carrying cost of Rs.300 per automobile?

- ► 40 cars
- ► 71 cars
- ► **100 cars**
- ► 126 cars

EOQ=square root of 2*2000*750 / 300 = 100

EOQ = square root of (2*annual QTY * Cost of order)/carrying cost per unit for whole year

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Question No: 39 (Marks: 1) - Please choose one

As the amount of _____ increases the present value of net tax-shield benefits of debt increases.

- ► **Debt**
- ► Common equity
- ► Preffered equity
- ► Assets

Question No: 40 (Marks: 1) - Please choose one

Why the present value of the costs of financial distress increases with increases in the debt ratio?

- ► Expected return on assets increases
- ► Present value of the interest tax shield is greater
- ► Equity tax shield is depleted
- ► **Probability of default and/or bankruptcy is greater**

Question No: 41 (Marks: 5)

What are the real markets effects of leverage on WAAC? (Answer the question in bulleted form only).

Answer: Real Markets Effects of leverage on WACC:

- Increase in leverage causes a a large increase in cost of equity
- Increase in leverage causes relatively small increase in cost of debt as compared to cost of equity
- As leverage increases WACC 1st falls because of tax saving shield.
- With further increase in leverage WACC fall to its minimum point which is the optimal point for capital structure
- Further increase in leverage causes increase in WACC because of bankruptcy risk

Question No: 42 (Marks: 5)

Suppose a Firm ABC has Total Assets of Rs.1000 and is 100% Equity based (i.e. Un-levered). There were 10 equal Owners and 5 of them want to leave. So the Firm takes a Bank Loan of Rs.500 (at 10%pa Mark-up) and pays back the Equity Capital to the 5 Owners who are leaving. Now, half of the Equity Capital has been replaced with a Loan from a Bank (i.e. Debt). What impact does this have on ROE?

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As the firm replaces equity with debt it is increasing financial leverage which is a cause of financial risk. The impact of debt on ROE is that ROE will increase but with the greater uncertainty hence greater will be the risk.

Question No: 43 (Marks: 10)

Stock X has a beta of 0.5, stock Y has a beta of 1.0, and stock Z has a beta of 1.25. The risk free rate is 10% and the expected market return is 18%.

a. Find the expected return on stock X

b. Find the expected return on stock Y

c. Find the expected return on stock Z

d. Suppose that you construct a portfolio consisting of 40% X, 20% Y and 40% Z. What is the beta of the portfolio?

Answer:

a. $r_M = 18\%$

$r_{RF} = 10\%$

$\beta = 0.5$

$r = r_{RF} + (r_M - r_{RF})\beta$

$= 10\% + (18\%-10\%)\ 0.5$

$= 10\% + 4\%$

$= 14\%$

b. $r_M = 18\%$

$r_{RF} = 10\%$

$\beta = 1.00$

$r = r_{RF} + (r_M - r_{RF})\beta$

$= 10\% + (18\%-10\%)\ 1.00$

$= 10\% + 8\%$

$= 18\%$

1. $r_M = 18\%$

$r_{RF} = 10\%$

$\beta = 1.25$

$r = r_{RF} + (r_M - r_{RF})\beta$

$= 10\% + (18\%-10\%)\ 1.25$

$= 10\% + 10\%$

$= 20\%$

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d. Beta of portfolio = $\beta_P = X\,\beta_X + Y\,\beta_Y + Z\,\beta_Z$

$= (40/100)0.5 + (20/100)1.0 + (40/100)1.25$

$= 0.4x0.5 + 0.2x1.0 + 0.4x1.25$

$= 0.2 + 0.2 + 0.5$

$= 0.9$

Question No: 44 (Marks: 10)

The ABC company is in the 35% marginal tax bracket. The current market value of the firm is Rs. 12 million. If there are no costs to bankruptcy:

a) What will be ABC' annual tax savings from interest deductions be if it issues Rs. 2 million of five years bonds at 12 % interest rate? What will be the value of the firm?

ANSWER: Annual Coupon payment each yr = 12% of 2,000,000

= 2000000 x 12/100

= 24000

Tax saving for 5 yrs = 5(35 % of 24000)

= 5(24000 x 35/100)

= 5x8400

= 42000

b) What will ABC' annual tax savings from interest deductions be if it issues Rs. 2 million of seven years bonds at 12 % interest rate? What will be the value of the firm?

Answer: Annual Coupon payment each yr = 12% of 2,000,000

= 2000000 x 12/100

= 24000

Tax saving for 7 yrs = 7(35 % of 24000)

= 7(24000 x 35/100)

= 7x8400

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= 58800

Question No: 45 (Marks: 10)

Using the Capital Asset Pricing Model (CAPM), determine the required return on equity for the following situations:

Situations	Expected return on market portfolio	Risk- free rate	Beta
1	16%	12%	1.00
2	18	8	0.80
3	15	14	0.70
4	17	13	1.20
5	20	15	1.60

What generalization can you make?

ANSWER: Required return= $r = r_{RF} + (r_M - r_{RF})\beta$

Where r_{RF} = risk free return

r_M = expected return on market

β = beta of stock

1. $r_M = 16\%$

$r_{RF} = 12\%$

$\beta = 1.00$

$r = r_{RF} + (r_M - r_{RF})\beta$

$= 12\% + (16\%-12\%)1.00$

$= 12\% + 4\%$

$= 16\%$

2. $r_M = 18\%$

$r_{RF} = 8\%$

$\beta = 0.80$

$r = r_{RF} + (r_M - r_{RF})\beta$

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= 8% + (18%-8%)0.80
= 8% + 8%
= 16%

3. r_M = 15%
r_{RF} = 14%
β = 0.70
$r = r_{RF} + (r_M - r_{RF})\beta$
= 14% + (15%-14%)0.70
= 14% + 0.70
= 14.7%

4. r_M = 17%
r_{RF} = 13%
β = 1.20
$r = r_{RF} + (r_M + r_{RF})\beta$
= 13% + (17%-13%)1.20
= 13% + 4.8%
= 17.8%

5. r_M = 20%
r_{RF} = 15%
β = 1.60
$r = r_{RF} + (r_M - r_{RF})\beta$
= 15% + (20%-15%) 1.60
= 15% + 8%
= 23%

GENERALIZATION: As beta of stock rises the return on stock also rises.

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