Final Exam Financial Management

Question One: True or False (10.5 points)
1- The greater the chance of a return far below the expected return, the greater the risk.

2- Standard deviation measures the market risk of an investment.

3- Coefficient of variation is an alternative measure of stand-alone risk.

4- Market risk is that part of a security’s stand-alone risk that cannot be eliminated by diversification.

5- Firm-specific, or diversifiable, risk is that part of a security’s stand-alone risk that can not be eliminated by diversification.

6- An investor can holding one stock earn a return commensurate with its risk.

7- If current growth is smaller than growth, current capital gains yield is greater than growth.

8- Sometimes changes in quarterly earnings are a signal of future changes in cash flows. This would not affect the current stock price.

9- In equilibrium The expected price, must equal the actual price, In other words, the fundamental value must be the same as the price.

10- Securities are normally in equilibrium and are “fairly priced.” One cannot “beat the market” except through good luck or inside information.

11- Most firms incorporate tax effects in the cost of capital. Therefore, focus on before-tax costs.

12- The cost of capital is used primarily to make decisions which involve raising and investing marginal capital. So, we should focus on new costs.
13- The A-T yield to investors and A-T cost to the issuer are higher on preferred than on debt, which is consistent with the higher risk of preferred.

14- Opportunity cost is the return stockholders could earn on alternative investments of equal risk.

15- Concerning AFN, Equation method is more flexible, More important, it allows different items to grow at different rates.

16- Higher dividend payout ratio will Increase AFN.

17- Higher profit margin will Increase AFN.

18- According to Bird-in-the-Hand Theory, Investors think dividends are higher risky than potential future capital gains, hence they like dividends.

19- Managers hate to cut dividends, so won’t raise dividends unless they think raise is sustainable. So, investors view dividend increases as signals of management’s view of the future.

20- Financial risk is the additional risk placed on the common stockholders as a result of the decision to finance with debt.

21- Financial leverage is the extent to which fixed assets are used in firm's operations.

Question Two: Choose the correct answer (25.5 points)

1- Firm expects to pay dividends at the end of each of the next four years of $1.00, $1.40, $2.00, and $3.00. If growth is then expected to level off at 9 percent, and if you require a 13 percent rate of return, how much should you be willing to pay for this stock?
   a. $55.35   b. $62.86   c. $81.75   d. $24.83   e. $50.22

2- Suppose you are willing to pay 20.00$ today for a share of stock which you expect to sell at the end of one year for $22.20. If you require an annual rate of return of 15 percent, what must be the amount of the annual dividend which you expect to receive at the end of Year 1?
   a. $1.00   b. $0.80   c. $1.60   d. $1.17   e. $2.20
3- A firm expects to pay a dividend of $2.00 one year from now. They expect the dividend to grow at a constant rate of 8%, forever. If the firm's required return is 12%, what is the expected stock price today?
   a. $16.67  b. $18.00  c. $25.00  d. $50.00  e. $54.00

4- A firm's CFO wants to estimate the firm's WACC, and has compiled the following information:
The firm's capital structure consists of 60% equity and 40% debt. The firm has bonds outstanding yield 8.75%.
The real-risk free rate is 5%.
The market risk premium is 6%.
The firm's beta is 1.4
The firm's tax rate is 40%.
The firm uses the CAPM to estimate the cost of equity, and does not account for any kind of flotation costs in the calculation of the cost of capital. What is the firm's weighted average cost of capital (WACC)?
   a. 9.44%  b. 9.76%  c. 10.14%  d. 11.54%  e. 12.02%

5- A firm's current ratio has steadily decreased over the past 3 years, from 2.9 three years ago to 1.1 today. What would a financial analyst be most justified in concluding?
   a. The firm's stock price has probably declined.
   b. The firm's debt ratio will not be affected.
   c. The firm's fixed assets turnover has probably deteriorated.
   d. The firm's liquidity position has probably deteriorated.

6- Burke Company has sales of $2,000,000 and an inventory turnover of 8.0. The firm's current ratio is 2.5, while its quick ratio is 2.0. What are Burke's current assets?
   a. $1,000,000  b. $400,000  c. $500,000  d. $1,500,000  e. $1,250,000

7- A firm has total assets of $20 million and a debt/equity ratio of 0.60. Its sales are $15 million, and it has total fixed costs of $6 million. If the firm's EBIT is $3 million, its tax rate is 40 percent, and the interest rate on all of its debt is 9 percent, what is the firm’s ROE?
   a. 6.98%  b. 13.75%  c. 5.25%  d. 11.16%  e. 11.25%

8- Holding other things constant, the additional funds required for financing a firm's operations would be increased with an increase in a firm's:
   d. Spontaneous liabilities.  e. Accruals.
9- All else equal, which of the following conditions would lead to a decrease in the additional funds needed?
   a. An increase of the dividend payout ratio.
   b. Accounts payable increase slower than sales.
   c. The firm has a lot of excess capacity.
   d. All of the above are correct.
   e. None of the above is correct.

10- Which of the following is a key determinant of operating leverage?
   a. Sales variability.
   b. Physical location of production facilities, for example in a high tax state.
   c. Cost of debt.
   d. Capital structure.
   e. Level of fixed costs.

11- Fisher Communications' common stock currently has a required return of 11.49%. The risk-free rate of interest is 5%, the market risk premium is 5.5%, and Fisher's corporate tax rate is 40%. The firm currently has 10% debt in its capital structure, but is considering recapitalizing to achieve a debt ratio of 50%. If the recapitalization is achieved, all else equal, what would the required return on Fisher Communications' common stock be? 
   a. 11.08%  b. 12.91%  c. 13.85%  d. 14.35%  e. 14.74%

12- Marsland Industries follows a strict residual dividend policy. The company has a capital budget of $4,000,000. It has a target capital structure which consists of 40 percent debt and 60 percent equity. Marsland forecasts that its net income will be $3,000,000. What will be the company's expected dividend payout ratio this year?
   a. 20%  b. 30%  c. 35%  d. 40%  e. 45%

13- Hurria co. is considering a large-scale recapitalization. Currently the company is financed with 25% debt and 75% equity. The company is considering increasing its level of debt until it is financed with 60% of debt and 40% of equity. The beta on its common stock at the current level is 1.5, the risk free is 6%, the market risk premium is 4% and the tax is 40%.

What is the current cost of capital?
   A. 16%  b. 12%  c. 21%  d. 7.5%
What is the new beta and the new cost of equity?

New beta is  

- a. 1.537  
- b. 2.555  
- c. 2.375  
- d. 2.753

New cost of capital  

- a. 6%  
- b. 12%  
- c. 15.5%  
- d. 21%

14- The Karama co. is currently in this situation: EBIT=4.7m; tax rate is 40%; value of debt is 2 m; interest rate is 10%; required rate of return for stocks is 15%; shares outstanding 600 000 shares; Po is $30; the firm's market is stable and it expects no growth and all earnings are paid out as dividends. What is market value of the firm?

- a. 18  
- b. 20m  
- c. 22m  
- d. 24m

WACC is  

- a. 14.11  
- b. 12.85  
- c. 11.85  
- d. 10.11

Question Three: answer the following (14 points)
What factors influence a company’s WACC?

What are the advantages and Disadvantages of stock Repurchases?

What are the differences between bonds and preferred stocks and common stocks?