Quiz 1: Corporate Finance

Answer all questions and show necessary work. Please be brief. This is an open books, open notes exam.

1. Corporate Governance/Risk Basics section.
    Each of the following multiple-choice questions is worth ½ point. Please pick only one answer for each question.
    a. In which of these companies would you (as a stockholder) be most concerned about poor corporate governance?
        i.   Long-tenured CEO with dispersed stockholding (lots of small holders)
        ii.   Short-tenured CEO with dispersed stockholding (lots of small holders)
        iii.   Long-tenured CEO with concentrated stockholding (some big holders)
        iv.   Short-tenured CEO with concentrated stockholding (some big holders)

    b. Dual class shares are hot; with many companies issuing two classes of shares, one with large voting rights held by founders and one with light or no voting rights offered to the public. If both classes of shares are traded, equally liquid and pay the same dividends, which of the following would you expect to see?
        i.   High voting-right shares trade at a discount on low-voting right shares.
        ii.   High voting-right shares trade at same price as low-voting right shares.
        iii.   High voting-right shares trade at a premium on low-voting right shares, with the premium being higher at well managed companies.
        iv.   High voting-right shares will trade at a premium on low-voting right shares, with the premium being higher at badly managed companies.

    c. One of the building blocks for the stock price maximization objective is efficient markets. If markets are efficient, which of the following would you expect after <u>unexpected good news</u> about the company?
        i.   No change in stock prices
        ii.   An immediate increase in the stock price and a gradual increase in the days thereafter
        iii.   An immediate increase in the stock price and a gradual decrease in the days thereafter
        iv.   An immediate increase in the stock price on the announcement but no price drift thereafter

    d. Many risk and return models in finance are built on the presumption that we live in a mean-variance world. However, you believe that investors value the possibility of big positive payoffs and that you are more likely to get big positive payoffs on small cap companies than big ones. Which of the following would you expect to observe investors doing?
        i.   Pay more for small cap stocks than for large cap stocks, with the same expected return and standard deviation.
        ii.   Pay less for small cap stocks than for large cap stocks, with the same expected return and standard deviation.

2. LAT Air is a Brazil-based airline that operates domestic flights in two Latin American countries and international flights to the US. Its revenue breakdown for the countries and other information are summarized below:

Country	Revenues (in millions of $R)	Govt Bond Rate (in local currency)	Govt Bond Rate (in US$)	Equity Mkt Std Deviation	Govt Bond Std Deviation
Brazil	800	10.00%	6.50%	24%	16%
Peru	200	5.50%	4.50%	20%	16%
US	600	2.50%	2.50%	15%	10%

The equity risk premium for the US is 5.5% and the beta for LAT Air is 1.2. Estimate the cost of equity for the company in Brazilian Reais. (You can assume that local currency sovereign default spreads are equal to foreign currency default spreads)   (3 points)

3. You are trying to estimate the levered beta for Corona Enterprises, a company that operates in three businesses, with the following breakdown:

	Movies	Casinos	Technology
Revenues (in millions of US $)	$500	$1500	$500
Enterprise Value/Sales	3.00	1.00	4.00
Unlevered Beta	0.9	0.6	1.2

The company is <u>trading at its fair value</u>, has no cash and $ 1 billion in debt outstanding. The marginal tax rate is 30%.

a. Estimate the levered beta for the company.   (2 points)

b. Now assume that Corona plans to sell its technology division for its fair value, <u>hold half the proceeds as a cash balance</u> and use the <u>remaining half to pay a special dividend</u>. Estimate the levered beta for the entire company's equity after the transaction.   (3 points)