

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. For corporate governance to work, you need an effective board of directors. Which of the following would you look for as the best indication of an effective board?
 - i. A board of long-tenured directors
 - ii. A board of directors with expertise in the business of the company.
 - iii. A board of directors with no conflicts of interest with management
 - iv. A board of directors that has overridden management (and the CEO) on key decisions.
 - v. A board of directors with diverse backgrounds and interests.
 - b. One proposal that has been floated to make companies behave in a more long-term way is to restrict voting at annual meetings only to shareholders who have held shares for more than a year. What effect do you think this restriction will have on shareholder and managerial power?
 - i. It will increase shareholder power and decrease managerial power
 - ii. It will decrease shareholder power and increase managerial power
 - iii. It will have no effect on the power of either shareholders or managers.
 - c. Assume that you believe that markets are efficient. In efficient markets, which of the following would you expect to observe?
 - i. Investors in well managed (good) companies should expect to earn higher returns than investors in badly managed firms, after adjusting for risk.
 - ii. Investors in badly managed (bad) companies should expect to earn higher returns than investors in well managed firms, after adjusting for risk.
 - iii. Investors in both well managed and badly managed firms should expect to earn the same returns, after adjusting for risk.
 - d. A portfolio of 50 small cap, volatile stocks will always have a higher standard deviation than a portfolio of 50 large cap, more stable stocks.
 - i. True
 - ii. False

2. Zona Hotels is a Latin American hotel company that derives 75% of its revenues in Brazil and 25% in Argentina and you have collected the following information on the countries:

	US \$ 10-year bond rate	Local Currency 10-year bond rate
Brazil	3.50%	7.50%
Argentina	8.50%	12.50%

If the risk free rate in US dollars is 1.50% and the equity risk premium in the US (a mature market) is 5%, estimate the cost of equity for Zona **in Brazilian Reals**. (The beta for Zona is 1.20 and equity is 1.30 times more volatile than the government bonds in emerging markets). (3 points)

3. You have run a regression for Ronan Chemicals, using stock price data from the last 2 years and arrived at the following:

$$\text{Return}_{\text{Ronan}} = 0.25\% + 1.035 \text{ Returns}_{\text{S\&P 500}}$$

During the two years (used in the regression), Ronan Chemicals had an average debt to equity ratio of 20% and faced a marginal tax rate of 25%. While the marginal tax rate is still 25%, Ronan Chemicals currently has a market capitalization of \$1,500 million and total debt outstanding of \$1,000 million. Starting with the regression beta, estimate the correct beta for the firm, given its changed financial leverage. (2 points)

4. CressKill Autos is an automobile company in two businesses, automobiles and energy, and you have been given the breakdown of the two businesses below:

	Revenue (\$ millions)	EV/Sales	Unlevered Beta
Autos	\$ 3,000.00	1.00	0.9
Energy	\$ 2,000.00	3.00	0.6

If CressKill has \$3,000 million in debt outstanding, estimate the levered beta for the company. (The marginal tax rate is 25%) (3 points)