The Effects of Taxes

You are comparing the debt ratios of real estate corporations, which pay the corporate tax rate, and real estate investment trusts, which are not taxed, but are required to pay 95% of their earnings as dividends to their stockholders. Which of these two groups would you expect to have the higher debt ratios?

- The real estate corporations
- The real estate investment trusts
- Cannot tell, without more information
Debt and Discipline

Assume that you buy into this argument that debt adds discipline to management. Which of the following types of companies will most benefit from debt adding this discipline?

- Conservatively financed (very little debt), privately owned businesses
- Conservatively financed, publicly traded companies, with stocks held by millions of investors, none of whom hold a large percent of the stock.
- Conservatively financed, publicly traded companies, with an activist and primarily institutional holding.
Debt & Bankruptcy Cost

Rank the following companies on the magnitude of bankruptcy costs from most to least, taking into account both explicit and implicit costs:

- A Grocery Store
- An Airplane Manufacturer
- High Technology company
Debt and Agency Costs

Assume that you are a bank. Which of the following businesses would you perceive the greatest agency costs?

- A Large Pharmaceutical company
- A Large Regulated Electric Utility

Why?
Financing Choices

You are reading the Wall Street Journal and notice a tombstone ad for a company, offering to sell convertible preferred stock. What would you hypothesize about the health of the company issuing these securities?

- Nothing
- Healthier than the average firm
- In much more financial trouble than the average firm
A recent article in an Asian business magazine argued that equity was cheaper than debt, because dividend yields are much lower than interest rates on debt. Do you agree with this statement

- Yes
- No

Can equity ever be cheaper than debt?

- Yes
- No
Many CFOs argue that using book value is more conservative than using market value, because the market value of equity is usually much higher than book value. Is this statement true, from a cost of capital perspective? (Will you get a more conservative estimate of cost of capital using book value rather than market value?)

- Yes
- No
Firm with mismatched debt
Firm with matched Debt
Differences in these actions
Expected Growth in EPS

\[ g_{\text{EPS}} = \frac{\text{Retained Earnings}_{t-1}}{\text{NI}_{t-1}} \times \text{ROE} \]

\[ = \text{Retention Ratio} \times \text{ROE} \]

\[ = b \times \text{ROE} \]

- Proposition 1: The expected growth rate in earnings for a company cannot exceed its return on equity in the long term.