Session 11: Post class test solutions

1. **d. The company has a bad track record on operating investments and you are afraid that the company will invest the cash.** Cash earns a low rate of return, but it is a fair rate of return. So, it is neither a value destroyer not does it create value. It is your concern that it may be "wasted" by investing a project/business where you earn less than the cost of capital that triggers the discount..
2. **b. 37.5%.** To compute the discount, assume that you invest $100 in Genesis today. If they continue to earn 3% less than the required return, as they have in the past, the expected cash flow each year will be 5% (8% - 3%). Discounting this expected cash flow at the required return o 8%:
    - Market value of fund = 5/.08 = $62.5
    - Discount as % = 1- 62.5/100 = .375 or 37.5%
3. **d. $270 million.** Since this is a minority holding, it is not reflected in your current operating income, cash flow or value of $250 million. You have to add the estimated market value of this holding to your value:
    - Estimated market value of holding = 10% of $200 m = $20 m
    - Estimated value of Pagano = $250 m + $20 m = $270 m
4. **a. $700 million.** To get to the value of equity, you need to add cash, subtract out debt and subtract out the estimated market value of the "minority" interest in the consolidated subsidiary.
    - Value of equity = 1000+ 100 – 200 - .4(500) = $ 700 m
    - Optimally, you would have liked to value the parent company as a stand-alone entity but you don't have that information.
5. **e. None of the above.** All of these assets contribute to generating the cash flows that you have discounted to arrive at your value of $ 2 billion. Adding them on to that value would be double counting.