Session 23: Post Class tests

1. We have argued that the right debt for a company is one where the debt payments are linked to operating performance, rising when operating cash flows are high and falling when they are low. Which of the following is a benefit of matching debt cash flows to asset cash flows?
   a. Reduced default risk, for any given level of debt
   b. Lower interest rates on debt, for any given level of debt
   c. Increased debt capacity
   d. Lower cost of capital, for any given level of debt
   e. All of the above

2. Assume that you are advising a Mexican company that derives all of its revenues in the US, has long-term projects and no pricing power. What is the right type of debt for the company?
   a. Long term, fixed rate US $ debt
   b. Long term, floating rate US $ debt
   c. Short term, floating rate US$ debt
   d. Short term, fixed rate Mexican Peso debt
   e. Long term, fixed rate Mexican Peso debt
   f. Long term, floating rate Mexican Peso debt
   g. None of the above

3. Banks are among the biggest issuers of preferred stock in the United States. Which of the following is the best explanation for why?
   a. Preferred stock is counted as part of regulatory capital
   b. Preferred stock is cheaper than common equity
   c. Preferred stock is cheaper than debt
   d. Preferred stock generates tax advantages
   e. All of the above
   f. None of the above

4. Commodity linked bonds tie coupon payments to commodity prices, rising (falling) as prices rise (fall). Which of the following is a good reason for a commodity company to issue commodity-linked bonds?
   a. To speculate on commodity prices
   b. To lower the interest rate paid on the bond
   c. To increase earnings over time
   d. To reduce default risk
   e. All of the above

5. An Indian company can borrow at 3% in Euros, 4% in US dollars and 9% in Indian rupees. The CFO of the company argues that the company should borrow in Euros because it is the cheapest debt. Is that true?
   a. True
   b. False
Session 21: Post class answers

1.  **e. All of the above.** By matching the cash flows on the debt up to the cash flows on the assets, you reduce default risk, which reduces your cost of borrowing (and capital) for any given level of debt and gives you the capacity to borrow more money, if you choose to.

2.  **b. Long term, floating rate US $ debt.** The projects are long term and the cash flows are in US $, yielding long term, US $ debt. The fact that the firm has pricing power will allow it to pass inflation through to its customers, making it a better candidate for floating rate debt.

3.  **a. Preferred stock is treated as part of regulatory capital.** Preferred stock is not cheaper than debt and does not yield any tax advantages. The cost of preferred stock may look lower than the cost of equity, but it is not cheaper, since you have to much larger fixed dividends on preferred stock.

4.  **c. To reduce default risk.** A commodity company that borrows money runs the risk of default risk when commodity prices drop. By issuing commodity linked bonds, it reduces that risk.

5.  **b. False.** You cannot compare borrowing rates in different currencies, since they have different inflation expectations embedded in them.