Session 27: Post Class tests

1. Kenna Software is a growing technology company that has just become profitable, reporting $15 million in the net income for the most recent year. An institutional investor is pushing the company to pay a dividend, since it is now a money making company. Would you agree?
   a. Yes
   b. No
   c. It depends (specify on what)

2. Klarman Inc. reported $150 million as net income on revenues of $1 billion in the most recent year; capital expenditures were $100 million, depreciation was $60 million and non-cash working capital was $80 million. Its revenues, earnings, capital expenditures and depreciation are expected to grow 10% next year, while non-cash working capital will remain at the same percent of revenues that it was in the most recent year. If Klarman pays out 60% of its earnings as dividends and currently has a cash balance of $200 million, what will its cash balance be at the end of next year?
   a. $188 million
   b. $214 million
   c. $242 million
   d. $260 million
   e. None of the above

3. You are an activist investor looking to put pressure on companies that have accumulated too much cash to return cash to stockholders. Which of the following companies would you put the most pressure on to return cash? (You can assume that they all have a cost of capital of 10% and an optimal debt ratio of 40%)
   a. Company A: ROC = 25%, Actual debt ratio = 40%
   b. Company B: ROC = 25%, Actual debt ratio = 60%
   c. Company C: ROC = 25%, Actual debt ratio = 10%
   d. Company D: ROC = 5%, Actual debt ratio = 40%
   e. Company E: ROC = 5%, Actual debt ratio = 60%
   f. Company F: ROC = 5%, Actual debt ratio = 10%
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1. **c. Maybe (probably no).** First, I have to check the FCFE. While the earnings are positive, it is possible that the company, being a growth company, has other reinvestments that make the FCFE negative. Second, I have to check future reinvestment needs to see if the company may need the cash in future years. It is likely that the company will not be able to pay dividends yet.

2. **b. $214 million.** First, compute the FCFE

   \[ \text{FCFE} = 150(1.1) + 60(1.1) - 100(1.1) - 0.08 (1100-1000) = 113 \]

   Note that working capital is currently 8% of revenues and will continue at that same percent next year.

   The dividends paid are 60% of net income = .60 (165) = 99

   Change in cash balance = 113 - 99 = +14

   New cash balance = 200 + 14 = $214 million

3. **f. Company F: ROC = 5%, Actual debt ratio = 10%.** An under levered company that takes bad projects has no business holding on to cash. It cannot claim that it needs the cash for great projects or as a buffer against a downturn (default).