

CÂU HỎI LUYỆN TẬP

CORPORATIVE ISSUERS CFA LEVEL 2

Question 1: Last year, Calfee Multimedia had earnings of \$4.00 per share and paid a dividend of \$0.30. In the current year, the company expects to earn \$5.20 per share. Calfee has a 30% target payout ratio. If the expected dividend for this year is \$0.51, what time period is Calfee most likely using in order to bring its dividend up to the target payout?

- A. 6 years.
- B. 4 years.
- C. 5 years.

Question 2: Which of the following statements about dividend policy is most accurate?

- A. A person who believes in the agency cost effect and a proponent of the "bird-in-hand" theory would have opposite views on dividend payout policy.
- B. A person who believes in bird-in-hand theory would have the same view as one that subscribes to the clientele theory.
- C. Investors view a stock repurchase as a positive signal and a stock issue as a negative signal.

Question 3: Francis Investment Inc.'s Board of Directors is considering repurchasing \$30,000,000 worth of common stock. Francis assumes that the stock can be repurchased at the market price of \$50 per share. After much discussion Francis decides to borrow \$30 million that it will use to repurchase shares. Francis' Chief Financial Officer (CFO) has compiled the following information regarding the repurchase of the firm's common stock:

- Share price at the time of buyback = \$50
- Shares outstanding before buyback = 30,600,000
- EPS before buyback = \$3.33
- Earnings yield = $\$3.33 / \$50 = 6.7\%$
- After-tax cost of borrowing = 4.0%
- Planned buyback = 600,000 shares

Based on the information above, after the repurchase of its common stock, Francis' EPS will be closest to:

- A) \$3.39.
- B) \$3.41.
- C) \$3.36.

Question 4: Which of the following statements about a stock repurchase is least accurate?

- A. A stock repurchase occurs when a large block of stock is removed from the marketplace.
- B. Disgruntled stockholders are forced to sell their shares, improving management's position.
- C. Management can distribute cash to shareholders at a favorable after-tax rate.

Question 5: Pearl City Breweries has 8 million shares outstanding that are currently trading at \$34 per share. The company is choosing whether to distribute \$22 million as dividends or to use the same amount to repurchase its shares. Ignoring tax effects, what will be the amount of total wealth from owning one share of Pearl City Breweries under each of these alternatives?

	<u>Cash dividend</u>	<u>Share repurchase</u>
A.	\$31.25	\$37.00
B.	\$34.00	\$34.00
C.	\$31.25	\$34.00

Passage (Question 6-9):

Rainham Inc. has never paid a dividend from the cash flows it generates from its projects; rather it likes to reinvest them in growing the business. Rainham Inc. has experienced a period of sustained growth but management is of the opinion that this growth rate will moderate and they have therefore decided to move to a dividend pay-out. The company's cost of equity is currently estimated to be 16%, with the industry's cost of equity at around 12%. The firm has set the objective of achieving a 70% pay-out ratio.

The board of directors of Rainham Inc. is worried about the impact of moving immediately to a 70% pay-out ratio; whilst this remains their long term objective they feel that a gradual build-up of the pay-out ratio to 70% would be more appropriate. The proposal is to set an initial dividend pay-out ratio in year 1 of 30% and then increase this over the following five years to 70%. Rainham Inc. has set a growth rate in earnings consistent with their long run ROE and target pay-out ratio.

The Commercial Director of Rainham Inc. believes that the board is overly concerned about investors' reaction to the change in dividend policy. He believes that dividend policy is influenced by the availability of investment opportunities, the future volatility of earnings, flotation costs and legal restrictions.

Question 6: According to Gordon, Litner, and Graham, what will be the impact of the dividend initiation on the cost of equity of Rainham Inc.?

- A. It will increase.

B. It will decrease.

C. Unchanged.

Question 7: Which of the following dividend policy is consistent with the Rainham Inc.'s proposed dividend policy of setting an initial dividend payout ratio to 30% and then increase this over the following five years to 70%?

A. Residual dividend model.

B. Dividend stability.

C. Target payout ratio.

Question 8: The Commercial Director has mentioned four out of six factors that influence dividend policy. Which of the following is least likely to be one of the remaining two factors not mentioned?

A. Clientele effect.

B. Taxation.

C. Financial flexibility.

Question 9: Rainham Inc. pays 35% taxes based on the U.S. tax laws and pays a dividend of \$0.90 a share. Assuming that the investor who receives Rainham Inc.'s dividend is in the 15% tax bracket. The effective tax rate on a dollar of earnings paid out as dividends will be:

A. Higher than 35%.

B. Equal to the investor's tax bracket of 15%.

C. Equal to the corporate tax rate of 35%.

Question 10: Which of the following would be least likely to help control the principal-agent relationship (PAR) problem?

A. Fire employees who misbehave.

B. Increase the asymmetry of information between the owners of the firm and the employees.

C. Alter the behavior of executives through goal setting.

Question 11: A company is most likely to have a high cost of capital if the firm has a low:

- A. total debt-to-EBITDA ratio.
- B. interest coverage (IC) ratio.
- C. debt-to-equity (D/E) ratio.

Question 12: When attempting to build a risk premium into the required returns of stocks in a developing country, an analyst should use the:

- A. country's weighted average cost of capital.
- B. country spread model.
- C. modified Gordon Growth model.

Question 13: The first step in evaluation of an announced corporate transaction is:

- A. preliminary valuation.
- B. the gathering of data.
- C. initial evaluation.

Question 14: Kavi Biswas, CFA, makes the following statements:

Statement 1:

Empirical studies suggest that corporate transactions taken during stronger economic times tend to create more value.

Statement 2:

Corporate transactions tend to be cyclical, increasing in prevalence during economic expansions and decreasing during contractions. Which statement is correct?

- A. Statement 1 only.
- B. Statement 2 only.
- C. Neither statement is correct.

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1. A	2. C	3. C	4. B	5. C	6. A	7. C	8. A	9. A	10. B
11. C	12. B	13. C	14. B						

Question 1: A

The formula to determine the expected dividend increase in a target payout approach is:

Expected increase in dividends = [(expected earnings × target payout ratio) – previous dividend] × adjustment factor

where the adjustment factor is 1 / number of years over which the adjustment will take place.

Using the numbers given:

$$\$0.51 - \$0.30 = [(\$5.20 \times 0.30) - \$0.30] \times (1 / n)$$

$$\$0.21 = [\$1.26] \times (1 / n)$$

$$\$0.21 / \$1.26 = 1 / n$$

$$n = \$1.26 / \$0.21$$

$$n = 6$$

Question 2: C

Investors view a stock repurchase as a positive signal and a stock issue as a negative signal. A repurchase may mean that management believes the stock is undervalued.

The other statements are false. A person who believes in the clientele effect and a proponent of the "bird-in-hand" theory would not have similar views on dividend policy. Clientele theory argues that different customers have different tax and other concerns and therefore will gravitate toward companies with payout policies that address those concerns. Under the agency cost theory, dividends reduce free cash flow that managers can use for empire building and hence, a high payout is preferred. According to the "bird-in-hand" theory, investors prefer dividends to capital appreciation because they view the former (D_1 / P_0) as less risky than the latter (g , or growth rate). Both approaches have similar (and not opposite) views on dividend policy.

Question 3: C

$$\text{Total earnings} = \$3.33 \times 30,600,000 = \$101,898,000$$

$$\begin{aligned} \text{EPS after buyback} &= \frac{\text{total earnings} - \text{after} - \text{tax cost of funds}}{\text{shares outstanding after buyback}} \\ &= \frac{\$101,898,000 - (600,000 \text{ shares} \times \$50 \times 0.04)}{(30,600,000 - 600,000) \text{ shares}} = \frac{\$100,698,000}{(30,000,000) \text{ shares}} = \$3.36 \end{aligned}$$

Since the after-tax cost of borrowing of 4% is less than the 6.7% earnings yield (E/P) of the shares, the share repurchase will increase Francis's EPS.

Question 4: B

A repurchase gives stockholders a choice. They can sell or not sell. Stock repurchase is also more tax-efficient as only those shareholders that choose to sell their shares would potentially have a tax liability.

Question 5: B

If the company pays a cash dividend, the dividend per share will be \$22 million/8 million = \$2.75. The value of its shares will be:

$$\frac{8,000,000 (\$34) - \$22,000,000}{8,000,000} = \frac{\$250,000,000}{8,000,000} = \$31.25$$

So the total wealth from owning one share will be \$31.25 + \$2.75 = \$34.00.

If the company repurchases shares, it can buy \$22 million/\$34 = 647,058 shares. The value of one share would then be:

$$\frac{8,000,000 (\$34) - \$22,000,000}{8,000,000 - 647,058} = \frac{\$250,000,000}{7,352,942} = \$34.00$$

If you remember that both a cash dividend and a share repurchase for cash leave shareholder wealth unchanged, this question does not require calculations of the amounts.

Question 6: B

According to the dividend preference theory (bird-in-the-hand argument), dividends are perceived to be of a lower risk than potential capital gains from reinvested earnings. Dividends have certainly, whereas future capital gains do not. A company that pays dividends will, therefore, have a lower cost of equity compared to a similar non-dividend paying firm.

Question 7: C

Target payout ratio is consistent with the proposed dividend policy of Rainham Inc. Under the target payout ratio approach, the management would define a target payout ratio and move toward the target payout ratio over time.

Question 8: A

The six factors that affect dividend policy are:

- Availability of investment opportunities
- Future earnings volatility
- Financial flexibility
- Tax considerations
- Flotation costs
- Contractual and legal restrictions

Question 9: A

U.S. tax rules are based on a double taxation system. As such, the effective tax rate will be higher than just the corporate tax rate of 35% as taxes paid would include both corporate tax and the tax paid on the dividend.

Question 10: B

Decreasing the asymmetry of information between the owners of the firm (principals) and executives (agents) would help to control the principal-agent relationship (PAR) problem.

The PAR problem arises from the agents (executives / employees) having more information about the company than the principals (owners / shareholders) and misusing that information to the advantage of the agents at the expense of the firm or principals.

The other two answer choices are methods for reducing the PAR problem by affecting the behavior of agents by setting goals and principles of behavior and removing agents who misbehave and violate ethics.

Question 11: B

Low interest coverage (IC) suggests that a firm has a reduced ability to service additional debt. Holding business risk constant, companies with higher proportions of debt in their capital structure are likely to face higher costs of capital.

Question 12: B

The country spread model uses data from a developed market, then adjusts it using the difference between the bond yields for the emerging and developed markets. Neither a modified Gordon Growth model nor a weighted average cost of capital will do this job.

Question 13: C

The first step in evaluation of an announced corporate transaction is initial evaluation. Within this step, analysts seek to answer four questions: what, why, when, and is it material.

Question 14: B

Statement 1 is incorrect. Empirical studies suggest that corporate transactions taken during weaker economic times tend to create more value.