

Name _____ ID _____

**PRINT YOUR NAME AND ID ON THE TEST, ANSWER SHEET AND FORMULA SHEET.
TURN IN THE TEST, OPSCAN ANSWER SHEET AND FORMULA SHEET.**

STUDENT CAN HAVE ONE LETTER SIZE FORMULA SHEET PREPARED BY STUDENT HIM/HERSELF.
FINANCIAL CALCULATOR/TI-83 OR THEIR EQUIVALENCES ARE ALLOWED.

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

- 1) Preferred stock is similar to common stock in the following way: 1) _____
 - A) as equity, both are subordinate to bondholders in the event of bankruptcy.
 - B) both preferred stock and common stock provide equal periodic dividends.
 - C) both contain a dividend growth factor.
 - D) both investments have a final maturity value set by the issuing agreement.

- 2) ABC Corp. common stock paid \$2.50 in dividends last year (D_0). Dividends are expected to grow at a 12-percent annual rate forever. If ABC's current market price is \$70.00, what is the stock's expected rate of return (nearest .01 percent)? 2) _____
 - A) 16.00%
 - B) 5.50%
 - C) 18.25%
 - D) 19.00%

- 3) Yanti Corp. preferred stock has a 5% stated dividend percentage, and a \$100 par value. What is the value of the stock if your required rate of return is 6% per year? 3) _____
 - A) \$30.00
 - B) \$100.00
 - C) \$94.05
 - D) \$83.33

- 4) Preferred stock is similar to a bond in the following way: 4) _____
 - A) both provide interest payments.
 - B) preferred stock always contains a maturity date.
 - C) both investments provide a stated income stream.
 - D) both contain a growth factor similar to common stock.

- 5) You observe Golden Flashes Common Stock selling for \$40.00 per share. The next dividend is expected to be \$4.00, and is expected to grow at a 2% annual rate forever. If your required rate of return is 14%, should you purchase the stock? 5) _____
 - A) Yes, because the present value of the expected future cash flows is less than \$40.
 - B) No, because the present value of the expected future cash flows is less than \$40.
 - C) No, because the present value of the expected future cash flows is greater than \$40.
 - D) Yes, because the present value of the expected future cash flows is greater than \$40.

- 6) Greenland Airlines has net income of \$1 million this year. The book value of Greenland Airlines common equity is \$5 million dollars. The company's dividend payout ratio is 70% and is expected to remain this way. What is Greenland Airlines' internal growth rate? 6) _____
 - A) 15%
 - B) 5.7%
 - C) 6.0%
 - D) 9%

- 7) Which of the following statements concerning the required rate of return on stocks is true? 7) _____
 - A) If risk is reduced, the required return will decrease because more investors are risk-averse.
 - B) The higher an investor's required rate of return, the higher the value of the stock.
 - C) The required return on preferred stock is generally higher than the required return on common stock.
 - D) The higher the risk, the higher the required return, other things being equal.

8) You are considering the purchase of a common stock that paid a dividend of \$2.00 yesterday. You expect this stock to have a growth rate of 10 percent for the next 3 years. The long-run normal growth rate after year 3 is expected to be 5 percent (that is, a constant growth rate after year 3 of 5% per year forever). If you require a 15 percent rate of return, how much should you be willing to pay for this stock? 8) _____

A) \$26.89 B) \$18.65 C) \$ 36.24 D) \$23.87

9) Nogrowth Corporation expects their dividend to stay at \$1.50 per share each year into the foreseeable future. Therefore, 9) _____

A) The stock will be valued at \$1.50 times the number of years an investor plans to keep it.
 B) The value of the stock can be estimated as \$1.50 divided by an investor's required rate of return.
 C) The value of the stock can not be determined using the dividend valuation model because the growth rate is zero.
 D) The free cash flow model will yield a higher stock value if free cash flow is greater than \$1.50 per share.

10) XYZ common stock is currently selling for \$8.00. It just paid a dividend of \$1.50 and dividends are expected to grow at a rate of 6% indefinitely. What is the required rate of return on XYZ's stock? 10) _____

A) 33.00% B) 26.00% C) 20.60% D) 18.00%

11) A project requires an initial investment of \$50,000. The project generates free cash flow of \$80,000 at the end of year 2. What is the internal rate of return for the project? 11) _____

A) 34.16% B) 44.08% C) 19.66% D) 26.44%

12) The Kitchen Inc. is considering the following 3 mutually exclusive projects. Projected cash flows for these ventures are as follows: 12) _____

Plan A	Plan B	Plan C
Initial	Initial	Initial
Outlay=\$4,000,000	Outlay=\$5,000,000	Outlay=\$1,750,000
Cash Flow:	Cash Flow:	Cash Flow:
Yr 1=\$ -0-	Yr 1=\$4,000,000	Yr 1=\$1,000,000
Yr 2= -0-	Yr 2= 3,000,000	Yr 2= -0-
Yr 3= -0-	Yr 3= 2,000,000	Yr 3=1,000,000
Yr 4= -0-	Yr 4= -0-	Yr 4=1,000,000
Yr 5=\$7,000,000	Yr 5= -0-	Yr 5=1,000,000

If the Kitchen has a 12% cost of capital, what decision should be made regarding the projects above?

- A) Accept plan A B) Accept plan B
 C) Accept plan C D) Accept Plans B and C

13) Palm, Inc. is considering two mutually exclusive projects, A and B. Project A costs \$75,000 and is expected to generate \$48,000 in year one and \$45,000 in year two. Project B costs \$80,000 and is expected to generate \$34,000 in year one, \$37,000 in year two, \$26,000 in year three, and \$25,000 in year four. Zellars, Inc.'s required rate of return for these projects is 10%. The modified internal rate of return for Project A and B, respectively, are: 13) _____

A) 16.49% and 15.74%. B) 19.43% and 13.40%.
 C) 14.19% and 15.74%. D) 14.19% and 13.40%.

- 14) You are considering investing in a project with the following year-end after-tax cash flows: 14) _____
- Year 1: \$57,000
Year 2: \$72,000
Year 3: \$78,000
Year 4: \$20,000
- If the initial outlay for the project is \$185,000, compute the project's internal rate of return.
A) 10.89% B) 5.54% C) 9.61% D) 6.98%
- 15) Which of the following methods of evaluating investment projects can properly evaluate projects of unequal lives? 15) _____
- A) The payback. B) The equivalent annual annuity.
C) The internal rate of return. D) The net present value.
- 16) Your firm is considering an investment that will cost \$750,000 today. The investment will produce cash flows of \$250,000 in year 1, \$300,000 in years 2 through 4, and \$100,000 in year 5. The discount rate that your firm uses for projects of this type is for year 1 through year 4 is 13.25%. However, you expect that you can reduce the discount rate to 12.5% for year 5. What is the investment's net present value? 16) _____
- A) \$147,544 B) \$149,525 C) \$147,613 D) \$132,000
- 17) Project A has an internal rate of return (IRR) of 15 percent. Project B has an IRR of 12 percent. Both projects have a required return of 14 percent. Which of the following statements is most correct? 17) _____
- A) Project B has a higher profitability index than Project A.
B) Both projects have a positive net present value (NPV).
C) If the required return were less than 14 percent, Project B would have a higher IRR than Project A.
D) Project A must have a higher NPV than project B.
- 18) We compute the profitability index of a capital budgeting proposal by 18) _____
- A) dividing the present value of the annual after tax cash flows by the cash investment in the project.
B) multiplying the cash inflow by the internal rate of return.
C) multiplying the internal rate of return by the cost of capital.
D) dividing the present value of the annual after tax cash flows by the cost of capital.
- 19) The disadvantage of the IRR method is that: 19) _____
- A) the IRR will always give the same project accept/reject decision as the NPV.
B) the IRR requires long, detailed cash flow forecasts.
C) the IRR gives equal regard to all returns within a project's life.
D) the IRR deals with cash flows.
- 20) Rent-to-Own Equipment Co. is considering a new inventory system that will cost \$450,000. The system is expected to generate positive cash flows over the next four years in the amounts of \$250,000 in year one, \$125,000 in year two, \$25,000 in year three, and \$100,000 in year four. Rent-to-Own's required rate of return is 10%. What is the payback period of this project? 20) _____
- A) 3.50 years B) 4.00 years C) 2.68 years D) 2.50 years

21) Which of the following statements about the net present value is true? 21) _____
 A) It produces a percentage result that is easy to describe.
 B) It is likely that there will be more than one NPV for a project.
 C) It has an inadequate reinvestment assumption.
 D) It may be used to select among projects of different sizes.

22) The advantages of NPV are all of the following except: 22) _____
 A) it allows the comparison of benefits and costs in a logical manner through the use of time value of money principles.
 B) it provides the amount by which positive NPV projects will increase the value of the firm.
 C) it can be used as a rough screening device to eliminate those projects whose returns do not materialize until later years.
 D) it recognizes the timing of the benefits resulting from the project.

23) All of the following are sufficient indications to accept a project **except** (assume that there is no capital rationing constraint, and no consideration is given to payback as a decision tool): 23) _____
 A) The net present value of an independent project is positive.
 B) The IRR of a mutually exclusive project exceeds the required rate of return.
 C) The profitability index of an independent project exceeds one.
 D) The NPV of a mutually exclusive project is positive and exceeds that of all other projects.

24) Initial Outlay Cash Flow in Period 24) _____

	1	2	3	4
\$4,000,000	\$1,546,170	\$1,546,170	\$1,546,170	\$1,546,170

The Internal Rate of Return (to nearest whole percent) is:

- A) 24% B) 20% C) 18% D) 10%.

25) The risk free rate of return is 4% and the expected return on the market portfolio is 12%. A firm has a beta of 1.8 and a standard deviation of returns of 16%. Its marginal tax rate is 30%. Analysts expect Starship's net income to grow by 8% per year for the next 5 years. Using the capital asset pricing model, what is Starship Enterprises' cost of retained earnings? 25) _____
 A) 22.2% B) 18.2% C) 18.4% D) 16.6%

26) The ABC Company is planning a \$100 million expansion. The expansion is to be financed by selling \$40 million in new debt and \$60 million in new common stock. The before-tax required rate of return on debt is 10 percent and the required rate of return on equity is 15 percent. If the company is in the 30 percent tax bracket, what is the firm's cost of capital? 26) _____
 A) 12.9% B) 9.7% C) 10.000% D) 11.8%

27) A company has preferred stock with a current market price of \$26.5 per share. The preferred stock pays an annual dividend of 4% based on a par value of \$100. Flotation costs associated with the sale of preferred stock equal \$1.50 per share. The company's marginal tax rate is 40%. Therefore, the cost of preferred stock is: 27) _____
 A) 15.09% B) 22.22% C) 16.00% D) 4.00%.

28) Cost of capital is: 28) _____
 A) the average cost of the firm's assets.
 B) a hurdle rate set by the board of directors.
 C) the rate of return that must be earned on additional investment if firm value is to remain unchanged.
 D) the coupon rate of debt.

29) Which of the following causes a firm's cost of capital (WACC) to differ from an investor's required rate of return on the company's common stock? 29) _____
 A) The market risk premium exceeds 12%.
 B) The fact that the risk free rate of interest has increased.
 C) The incurrence of flotation costs when new securities are issued.
 D) None of the above – the WACC and required return are the same

30) Durocorp has a target capital structure of 50% debt and 50% equity. Durocorp is planning to invest in a project that will necessitate raising new capital. New debt will be issued at a before-tax yield of 15%, with a coupon rate of 10%. The equity will be provided by internally generated funds so no new outside equity will be issued. If the required rate of return on the firm's stock is 20% and its marginal tax rate is 40%, compute the firm's cost of capital. 30) _____
 A) 14.5% B) 17.5% C) 15.00% D) 13.68%

31) Given the following information on S & G Inc.'s capital structure, compute the company's weighted average cost of capital. 31) _____

Type of Capital	Percent of Capital Structure	Before-Tax Component Cost
Bonds	40%	10%
Preferred Stock	10%	15%
Common Stock (Internal Only)	50%	20%

The company's marginal tax rate is 40%.
 A) 15.5% B) 10.6% C) 13.9% D) 15%

32) A Company has a capital structure made up of 40% debt and 60% equity and a tax rate of 30%. A new issue of \$1,000 par bonds maturing in 20 years can be issued with a coupon of 9% at a price of \$1,098.18 with no flotation costs. The firm has no internal equity available for investment at this time, but can issue new common stock at a price of \$45. The next expected dividend on the stock is \$2.80. The dividend for Mars Co. is expected to grow at a constant annual rate of 5% per year indefinitely. Flotation costs on new equity will be \$5.00 per share. The WACC for the firm is: 32) _____
 A) 9.76% B) 9.44% C) 9.20% D) 14%

33) Which of the following should NOT be considered when calculating a firm's WACC? 33) _____
 A) After-tax cost of accounts payable B) Cost of newly issued preferred stock
 C) After-tax YTM on a firm's bonds D) Cost of newly issued common stock

34) Bell Corp. has a preferred stock that pays a dividend of \$2.40. If you are willing to purchase the stock at \$11, what is your required rate of return (round your answer to the nearest .1% and assume that there are no transaction costs)? 34) _____
 A) 9.1% B) 11.0% C) 20.1% D) 21.8%

- 35) The cost of new preferred stock is equal to: 35) _____
A) the preferred stock dividend divided by the market price.
B) the preferred stock dividend divided by its par value.
C) preferred stock dividend divided by the net selling price of preferred.
D) $(1 - \text{tax rate})$ times the preferred stock dividend divided by net price.
- 36) Nogrowth Corporation expects their dividend to stay at \$0.50 per share each year into the foreseeable future. Therefore, 36) _____
A) The stock will be valued at \$0.50 times the number of years an investor plans to keep it.
B) The value of the stock can be estimated as \$0.50 divided by an investor's required rate of return.
C) The free cash flow model will yield a higher stock value if free cash flow is greater than \$0.50 per share.
D) The value of the stock can not be determined using the dividend valuation model because the growth rate is zero.

TRUE/FALSE. A. True B. False

- 37) Preferred stock and common stock issued by the same firm will have the same required return because the riskiness of the firm's cash flows is the same for both securities. 37) _____
- 38) Under majority voting a majority (>50%) shareholder will just be able to elect a simple majority of the board of directors. 38) _____
- 39) An acceptable project should have a net present value greater than or equal to zero and a profitability index greater than or equal to one. 39) _____
- 40) Shareholders, as owners of the corporation, face unlimited liability for the corporation's debts, while bondholders, as creditors, may only lose the value of their investment if the company goes bankrupt. 40) _____
- 41) An opportunity cost is a relevant incremental cost for capital budgeting decisions. 41) _____
- 42) If the expected growth rate for dividends is zero, then the value of common stock will be equal to the current dividend. 42) _____

Answer Key

Testname: TEST III

- 1) A
- 2) A
- 3) D
- 4) C
- 5) B
- 6) C
- 7) D
- 8) D
- 9) B
- 10) B
- 11) D
- 12) D
- 13) C
- 14) C
- 15) B
- 16) C
- 17) D
- 18) A
- 19) B
- 20) A
- 21) D
- 22) C
- 23) B
- 24) B
- 25) C
- 26) D
- 27) C
- 28) C
- 29) C
- 30) A
- 31) C
- 32) B
- 33) A
- 34) D
- 35) C
- 36) B
- 37) FALSE
- 38) FALSE
- 39) TRUE
- 40) FALSE
- 41) TRUE
- 42) FALSE