Strategic Financial Management – Summary of sample exam questions

True/false statements

Williams Act enables a long, protracted takeover battle.

- **True**, Williams Act imposed greater disclosure by bidders and a longer bidding period.

For targets, the CAR cash is lower than the CAR stock.

- **False**, the other way around because of tax advantages. In a cash payment, the target will need to be compensated for the capital gains tax he needs to pay. So, the bid will be higher resulting in a higher return for the target.

Companies in Anglo-Saxon countries are more likely to take on large debt strategies than companies in Continental countries.

- **True**, Anglo-Saxon countries have a more efficient bankruptcy system, thus lower costs of financial distress than Continental countries. Therefore, it is more likely that large debt strategies are used in Anglo-Saxon countries.

The value expropriation of existing bondholders is the most important factor in LBO's.

- **True**, the massive increase in leverage lowers the value of the existing debt instrument of the existing bondholders. There is a higher probability of bankruptcy.
- However, the losses of the bondholders are smaller than the gains of the shareholders.

During a recession empirical evidence is found that share repurchases decrease in number, which is consistent with Rappaport's model. **False**

- First part of statement is true: in a recession, firms want to hold on to their cash, hence they will do fewer repurchases.
- Second part of statement is false: Rappaport's model states that the return of share repurchases will increase when the stocks are more undervalued. Undervaluation occurs when the intrinsic value of the share is much higher than the market value. In a recession, the stock prices are low, so possibly more undervaluation. You can buy the shares very cheaply.
- The decrease in number of shares repurchases in a recession is not consistent with the Rappaport model.

In the united states takeover defences which focus on protecting board control are the most effective.

- **True**, as in the US the board of directors has the most power and bidding firms are focused on convincing the power centre, they will try to convince the board of directors of the takeover. Therefore, the most effective takeover defences are the ones that focus on protecting board control. (such as staggered board or dead hand provisions).

If a parent company has a lot of growth opportunities, it is more likely to do a carveout than a spin-off.

- **True**, if a parent company has a lot of growth opportunities, it will need a lot of funding to support the growth. To have immediate access to cash, a carve out is more likely. Contrary to a spin-off, carve out results in a new entity where the equity is issued to the public (like in an IPO) and generates a cash inflow to the firm.

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Investors want to pay more for a conglomerate because they are much more diversified

- **False**, a conglomerate is often trading at a conglomerate discount (hence, money is left on the table), because individual investors prefer diversifying their portfolio based on their own preferences, not based on managerial decisions. E.g., in the conglomerate GBL Group, not all investors are interested in Umicore, whereas they are very interested in Ontex. They will purchase and sell their share in GBL at a discount.

Open market repurchases give highest return.

- **False**, they have the lowest returns. This is partly due the fact that OMRs are also the smallest deals.

Debtholders have the residual claim on a firm's cashflows.

- **False, Only shareholders because of RESIDUAL claim in question. Residual claim = leftover value after all claims have been paid.**

A problem with tracking stocks is that it increases the conglomerate discount.

- **False**, advantage decreases conglomerate discount. A lot of firms use the tracking stocks to get rid of the conglomerate discount.

Because LBO (or lev recap) increases the involvement of debtholders, the agency costs will increase.

- **False**, more insider ownership results in more alignment and less agency costs. There will also be less FCF left to mess around with for managers.

If the parent company has bad financial health, then a spin-off will be more likely than a carve-out.

- **False**, carve out might increase external cash funds through IPO, whereas a spin-off does not generate immediate cash.

Voluntary liquidation is more likely when insiders own a large stake in shares.

- **True**, the managers own a lot of shares, so if they liquidate, they will get a lot of money.

After LBO (or lev recap), a great part of wealth is created because much less taxes must be paid to the government.

- **False**, there are at first interest tax shields, but in the end of the process, when the LBO reverses at exit strategies (SIPO) there will be taxes paid on capital gains.

<u>Multiple Choice</u>

1. What gives highest return if you get:
    1. Preferred stock for debt → negative
    2. Common stock for debt → negative
    3. **Preferred stock for common stock → positive**
    4. Common stock for preferred stock → negative
2. Reorganisation
    1. **Management keeps control**
    2. Court appoints someone who takes control of company → liquidation only
    3. Conducts court control
3. Company would choose carve-out if
    1. **Stock market performance is high**
    2. **Financial distress**

4. If you want to avoid the results of an event study being influenced by business-related information that has nothing to do with the event, it is best to opt for
    1. **A narrow event window**
    2. A short clean period
    3. A relevant index as a benchmark
    4. A small number of enterprises in the sample
5. The returns of a merger arbitration fund are:
    1. Not sensitive to market risk, only deal risk is relevant
    2. Sensitive to market risk, especially if markets perform ~~well~~
    3. Not sensitive to interest rates, only deal risk is relevant
    4. **Sensitive to market risk, especially where markets are performing poorly.**
6. Management entrenchment (= agency costs → negative combined return and negative correlation with target return)
    1. Increases target's return, increases bidder's return
    2. **Increases target's return, decreases bidder's return**
    3. Decreases target's return, increases bidder's return
    4. Decreases target's return, decreases bidder's return
7. What is the smallest threat to your credit risk?
    1. Leveraged recap (leverage increases = credit risk)
    2. **Dual stock recap** (no increase in leverage = smallest impact on credit risk)
    3. Open market repurchases (leverage increases a little bit)
    4. Leveraged buy-out (leverage increases extremely)
8. With a FTPO, which statement is correct?
    1. **Non-tendering shareholders create most wealth, but tendering shareholders get more return.**
    2. Non-tendering shareholders create most wealth therefore get most return
    3. Tendering shareholders create most wealth therefore get most return
    4. Tendering shareholders create most wealth, but non-tendering shareholders get more return
9. Which company is *less* likely to become a take-over target (LBO/lev recap/…)?
    1. **A high-tech company in Italy** (risky + not efficient solvency systems)
    2. A high-tech company in Sweden
    3. A burger restaurant in Italy
    4. A burger restaurant in Sweden
10. Which company is *less* likely to become a take-over target?
    1. A firm with low leverage ratio
    2. **A firm with high growth of sales**
    3. A firm with low valuation
    4. A small firm
11. What is *not* a potential motive for repurchasing shares?
    1. Takeover defence against hostile takeovers
    2. Neutralize dilution effects of employee stock option plans
    3. **Reduce the company's leverage ratio.**
    4. Signal of undervaluation of stock price
12. Merger arbitrageurs will decide to take on a deal when his:
    1. Probability of failure bigger than market consensus
    2. Probability of failure equal to market consensus
    3. **Probability of failure lower than market consensus**
    4. Probability of failure does not matter

13. Highest return?
    1. Asset sale
    2. **Spin-off with focus on core**
    3. Spin-off without focus
    4. Carv-out
14. Ex-ante costs of financial distress are charged to?
    1. Bondholder
    2. **Shareholder**
    3. State (by deductible interest)
    4. Suppliers and customers
15. Correct statement according to M&M?
    1. Mergers never create value
    2. **Mergers can create value if the ideal world assumption is left out**
    3. …
