

Strategic Financial Management

Restructuring & M&A Strategies

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Sample exam questions

Sample true/false questions

Briefly explain why the following statements are true or false:

A spin-off is an ideal method for generating cash which the parent company can use to finance its growth.

False:

Contrary to carve-outs, spin-offs do not generate cash: shares of the new entity are distributed (for free) among the parent's existing shareholders

High-leverage strategies (e.g. LBOs) are better suited for companies in traditional industries than for high-tech companies.

True:

Traditional industries: revenue growth, cash flows, profits, etc. are more predictable, which leads to lower uncertainty about the company's ability to meet its obligations

+ companies in traditional industries (on average) have fewer growth opportunities: lots of cash flow can be used for reducing debt instead of for investing

The announcement returns of open market repurchases are, on average, larger than the announcement returns of alternative share repurchase methods.

False:

Average CAR of OMRs are much lower than those of Dutch auctions, transferable put rights or fixed price tender methods. Reason: the percentage of repurchased shares in OMRs is much smaller, hence the lower announcement returns.

Sample multiple choice questions

In multiple choice questions, only one of the alternatives is correct. A correction for guessing of $1/3^{\text{rd}}$ of the question's score is applied for incorrect answers (i.e. + 1 for a correct answer; -1/3 for an incorrect answer; 0 for an omitted answer).

If you want to avoid that an event study's results are affected by non-event related company-specific information, it is best to:

- ☐ (a) **use a narrow event window**
- ☐ (b) use a short clean period
- ☐ (c) select a relevant benchmark index
- ☐ (d) include a small number of companies in the sample

A merger arbitrage fund's returns are:

- ☐ (a) not sensitive to market risk, only deal risk is relevant
- ☐ (b) sensitive to market risk, especially in bull markets
- ☐ (c) not sensitive to interest rates, only deal risk is relevant
- ☐ (d) **sensitive to market risk, especially in bear markets**

What is not a potential motive for repurchasing shares?

- ☐ (a) takeover defense against hostile takeovers
- ☐ (b) neutralize dilution effects of employee stock option plans
- ☐ (c) **reduce the company's leverage ratio**
- ☐ (d) signal of undervaluation of stock price

Sample numerical application question

Gladstone Manufacturing is a stock-exchange quoted company which is predominantly equity financed. Gladstone's share price is €21.00. There are 60 million shares outstanding, 25% of which are held by insider shareholders. The corporate tax rate is 30%.

The (simplified) balance sheet of Gladstone (in million EUR) is reported below:

Fixed Assets	210	Equity	300
Cash	15	Debt	50
Other current assets	125		
Total assets	350	Debt + Equity	350

Gladstone wants to do a leveraged recapitalization for 30% of the current market value of equity. The interest rate it will pay on the new debt is 7%.

a) What will the balance sheet look like after the leveraged recap?

Market value of equity = 21 x 60 = 1260 m
30% of 1260 m = 378 m

<i>Fixed Assets</i>	<i>210</i>	<i>Equity</i>	<i>-78</i>
<i>Cash</i>	<i>15</i>	<i>Debt</i>	<i>428</i>
<i>Other current assets</i>	<i>125</i>		
<i>Total assets</i>	<i>350</i>	<i>Debt + Equity</i>	<i>350</i>

- b) What is the new market value of equity after the recap, taking into account the tax shield of interest payments? (ignore potential costs of financial distress)

Value additional tax shield = $378 \times 0.3 = 113.4$

Previous equity value = 1260

New equity value = $1260 + 113.4 - \text{extra debt} = 1373.4 - 378 = 995.4$

Alternative:

Total value before recap = value of debt + market value of equity = $50 + 1260 = 1310$

Total value after recap = $1310 + \text{additional tax shield} = 1310 + 113.4 = 1423.4$

Equity value after recap = total value – debt = $1423.4 - 428 = 995.4$

- c) What is Gladstone's expected share price after the recap?

$P = \text{Market value equity} / (\text{previous \# shares} - \text{shares purchased})$

$= \text{Market value equity} / (\text{previous \# shares} - \text{amount repurchased} / P)$

$= 995.4 / (60 - 378 / P)$

$P = 22.89 (+9\%)$

- d) The recap will be executed via a Dutch auction repurchase of shares. Suppose the reservation price of the shareholders (V) is represented by a linear function $V(r) = a + b \times r$, where r = the number of offered shares (in millions). What are the intercept and the slope of this function for Gladstone?

Intercept = current stock price = 21

Slope:

Number of repurchased shares = $378/22.89 = 16,513,761$

This number must lead to an equilibrium price of €22.89

$$V(16.5138) = 21 + 16.5138 \times b = 22.89$$

$$b = 1.89/16.5138 = 0.1145$$

function:

$$V(r) = 21 + 0.1145 r$$

- e) Suppose that the repurchased shares are destroyed and that the insider shareholders decide not to sell any of their shares. What will be the percentage of shares owned by insiders after the recap?

16.5138 m shares repurchased

$60 - 16.5138 = 43.4862$ m shares remaining after recap

Number of insider shares = $25\% \times 60 = 15$ m

Percentage of insider shareholdings after recap = $15/43.4862 = 34.49\%$