Question 1
L2CF-ITEMSET-PQ2721-1411
LOS: LOS-7770
Lesson Reference: Lesson 2: Target Company Valuation
Difficulty: medium

Use the following information to answer the next three questions:

Peter Parker, CFA, is reviewing the recent financials of MicroTron Inc. He has gathered the following information for his analysis:

Net income = £1,820,000
Depreciation expense = £1,000,000
Interest income = £800,000
Interest expense = £1,200,000
Capital expenditures = £1,450,000
Changes in deferred taxes = £500,000
Changes in net working capital = £750,000
Marginal tax rate = 30%

i.
Unlevered income is *closest* to:

- ○ 2,220,000
- ○ 1,820,000
- ● 2,100,000

Rationale
This Answer is Correct

Unlevered income = Net income + Net interest expense after tax

Unlevered income = 1,820,000 + (1,200,000 − 800,000) (1 − 0.3) = **2,100,000**

ii.
Net operating profit less adjusted taxes is *closest* to:

- ○ 2,720,000
- ○ 2,880,000
- ● 2,600,000

Rationale
This Answer is Correct

NOPLAT = Unlevered income + Changes in deferred taxes

NOPLAT = 2,100,000 + 500,000 **= 2,600,000**

iii.
Free cash flow to the firm is *closest* to:

- ● 1,400,000

- 1,680,000
- 1,520,000

Rationale

This Answer is Correct

FCFF = NOPLAT + Noncash charges − Change in NWC investment − CAPex

FCFF = 2,600,000 + 1,000,000 − 750,000 − 1,450,000 = **1,400,000**

Question 2
L2CF-TB0019-1412
LOS: LOS-7700
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Which of the following motivations for a merger is *least likely* to be in the best interests of a conglomerate's shareholder?

- ○ Acquiring unique capabilities and resources.
- ◉ Diversification.
- ○ Tax considerations.

Rationale

This Answer is Correct

Although diversification seems like a rational motive for a merger, in practice it is typically not in the best interests of the conglomerate's shareholders since investors can choose to diversify their own portfolio in capital markets at less expense. The company should focus on the areas where it has competitive advantage in order to maximize value to shareholders.

Question 3
L2R28TB-ITEMSET-AC004-1512
LOS: LOS-7690
LOS: LOS-7770
LOS: LOS-7760
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium

Use the following information to answer the next three questions:

Blooms Soft Drinks (BSD) produces eight different kinds of cola drinks, six juices, and one brand name chocolate milk. BSD is expected to have higher than industry average free cash flow growth for the next three years, but its growth will decline to the industry average of 2.9 percent growth in free cash flows afterward.

At the end of 20X4, Montana Milk Inc. (MMI), which sells a variety of milk products, has targeted BSD and created the three-year pro forma cash flow analysis shown below. MMI uses the discounted cash flow method together with a weighted average cost of capital of 14.3 percent. The estimates in thousands of U.S. dollars are based on the current BSD financial statements.

	20X5E	20X6E	20X7E
NOPLAT*	2,480	3,961	5,237
Depreciation	583	961	1,641
Increase working capital	411	483	593
Capital expenditures	1,210	1,831	2,496

* NOPLAT (net operating profit after tax) = net income + net after-tax interest + change in deferred taxes.

At the same time, BSD is privately contemplating a takeover of Charm's Tree Farm, in which it would make significant changes in its capital structure, using leverage to finance the takeover. The president of BSD, citing a diversification motive for the takeover, has suggested to its board that its risk exposure would change with the takeover, leading to a higher cost of borrowing. BSD has already made free cash flow projections for Charm's Tree Farms in completing its analysis of the possible takeover.

i.
The merger between Montana Milk Inc. and Bloom Soft Drinks would *most likely* be characterized as:

- vertical.
- horizontal. (selected)
- conglomerate.

Rationale
This Answer is Correct
This is most likely a horizontal merger because both firms produce milk products, although BSD has only one milk product.

Rationale
This Answer is Correct
This is most likely a horizontal merger because both firms produce milk products, although BSD has only one milk product.

Rationale

This Answer is Correct

This is most likely a horizontal merger because both firms produce milk products, although BSD has only one milk product.

ii.

The value of BSD as a target is *closest to*:

- $16.4 million.
- $25.8 million.
- $28.7 million.

Rationale

This Answer is Incorrect

First, determine the free cash flow for the three-year pro forma period:

> FCF = Net income + Net after-tax interest + Change in deferred taxes + Non-cash charges − Increase in working capital – Capital expenditures
> NOPLAT + Non-cash charges – Increase in working capital – Capital expenditures
> 20X5 FCF = 2,480 + 583 – 411 – 1,210 = 1,442
> 20X6 FCF = 3,961 + 961 – 483 – 1,831 = 2,608
> 20X7 FCF = 5,237 + 1,641 – 593 – 2,496 = 3,789

Next, calculate the end of year three (20X7) terminal value:

$$\mathrm{TV_T} = \frac{\mathrm{FCF_T} \times (1+g)}{\mathrm{WACC} - g} = \frac{\$3{,}789 \times (1+0.029)}{0.143 - 0.029} = \$34{,}200$$

The last step is to discount the free cash flows and terminal value back to today using your financial calculator. Hint: The detail is shown below, but we recommend knowing how to use the financial calculator's discounted cash flow functions to find the same solution.

$$\mathrm{PV} = \frac{\$1{,}442}{(1+0.143)^1} + \frac{\$2{,}608}{(1+0.143)^2} + \frac{\$3{,}789 + 34{,}200\ (\text{TV at end of 20X7})}{(1+0.143)^3} = \$28{,}698 \cong \$28.7\text{ million}$$

Rationale

This Answer is Incorrect

First, determine the free cash flow for the three-year pro forma period:

> FCF = Net income + Net after-tax interest + Change in deferred taxes + Non-cash charges − Increase in working capital – Capital expenditures
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Rationale

This Answer is Incorrect

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> FCF = Net income + Net after-tax interest + Change in deferred taxes + Non-cash charges − Increase in working capital – Capital expenditures
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iii.

Disadvantages to Montana Milk Company in using its chosen valuation model include:

- ○ there is no estimate of intrinsic value on which to base a takeover bid.
- ○ changes to cash flow estimates for BSD after it takes over Charm's Tree Farms are not easily modeled.
- ◉ changes in the target capital structure and weighted average cost of borrowing can lead to an inefficient takeover bid.

Rationale

This Answer is Incorrect

The discounted cash flow method has several disadvantages when used as a model to determine target value during takeovers. One large drawback is its inability to accurately reflect changing market conditions, especially changes in the target's basic risk structure. It will be difficult to make an accurate estimate of the relevant discount rate to use in discounting free cash flow projections because of the uncertainty surrounding the target's (BSD combined with Charm's Tree Farms) new structure. This is likely to lead to a bid that does not adequately reflect the true value of the target.

Because BSD has already made free cash flow projections for Charm's Tree Farms, the changes in BSD's free cash flows can be estimated by Montana Milk.

Rationale

This Answer is Incorrect

The discounted cash flow method has several disadvantages when used as a model to determine target value during takeovers. One large drawback is its inability to accurately reflect changing market conditions, especially changes in the target's basic risk structure. It will be difficult to make an accurate estimate of the relevant discount rate to use in discounting free cash flow projections because of the uncertainty surrounding the target's (BSD combined with Charm's Tree Farms) new structure. This is likely to lead to a bid that does not adequately reflect the true value of the target.

Because BSD has already made free cash flow projections for Charm's Tree Farms, the changes in BSD's free cash flows can be estimated by Montana Milk.

Rationale

This Answer is Incorrect

The discounted cash flow method has several disadvantages when used as a model to determine target value during takeovers. One large drawback is its inability to accurately reflect changing market conditions, especially changes in the target's basic risk structure. It will be difficult to make an accurate estimate of the relevant discount rate to use in discounting free cash flow projections because of the uncertainty surrounding the target's (BSD combined with Charm's Tree Farms) new structure. This is likely to lead to a bid that does not adequately reflect the true value of the target.

Because BSD has already made free cash flow projections for Charm's Tree Farms, the changes in BSD's free cash flows can be estimated by Montana Milk.

Question 4
L2R28TB-AC016-1512
LOS: LOS-7730
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Box Company operates in a mature industry, with few new entrants but some growth opportunities. Box hopes to find operational efficiencies by merging. The *least likely* merger that would achieve this goal is:

- ○ vertical.
- ○ horizontal.
- ● conglomerate.

Rationale

✗ **vertical.**

Operational efficiencies can be achieved through both horizontal and vertical mergers, but are much less likely to occur when two unrelated firms merge to form a conglomerate. In fact, some conglomerate mergers experience almost zero synergies.

Rationale

✗ **horizontal.**

Operational efficiencies can be achieved through both horizontal and vertical mergers, but are much less likely to occur when two unrelated firms merge to form a conglomerate. In fact, some conglomerate mergers experience almost zero synergies.

Rationale

✓ **conglomerate.**

Operational efficiencies can be achieved through both horizontal and vertical mergers, but are much less likely to occur when two unrelated firms merge to form a conglomerate. In fact, some conglomerate mergers experience almost zero synergies.

Question 5
L2R28TB-AC020-1512
LOS: LOS-7790
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium
Charles Publishing offers $20 per share for Quality Textbooks. Charles' stock price is $82 while Quality sells for $16 and has 50 million outstanding shares. If expected synergies are $300 million, the gain to the shareholders of Charles Publishing is *closest* to:

- (selected) $100 million.
- $150 million.
- $300 million.

Rationale
✓ **$100 million.**

$$\begin{array}{ll} \text{Current market value of Quality Textbooks:} & \$16 \times 50 \text{ million} = \$800 \text{ million} \\ \text{Total cost of acquisition (takeover bid) :} & \$20 \times 50 \text{ million} = \$1 \text{ billion} \\ \text{Premium paid to Quality's shareholders:} & \$1 \text{ billion} - 800 \text{ million} = \$200 \text{ million} \\ \text{Gain to Charles Publishing's shareholders:} & \$300 \text{ million in synergies} - 200 \text{ million premium} = \$100 \text{ milli} \end{array}$$

Rationale
✗ **$150 million.**

$$\begin{array}{ll} \text{Current market value of Quality Textbooks:} & \$16 \times 50 \text{ million} = \$800 \text{ million} \\ \text{Total cost of acquisition (takeover bid) :} & \$20 \times 50 \text{ million} = \$1 \text{ billion} \\ \text{Premium paid to Quality's shareholders:} & \$1 \text{ billion} - 800 \text{ million} = \$200 \text{ million} \\ \text{Gain to Charles Publishing's shareholders:} & \$300 \text{ million in synergies} - 200 \text{ million premium} = \$100 \text{ milli} \end{array}$$

Rationale
✗ **$300 million.**

$$\begin{array}{ll} \text{Current market value of Quality Textbooks:} & \$16 \times 50 \text{ million} = \$800 \text{ million} \\ \text{Total cost of acquisition (takeover bid) :} & \$20 \times 50 \text{ million} = \$1 \text{ billion} \\ \text{Premium paid to Quality's shareholders:} & \$1 \text{ billion} - 800 \text{ million} = \$200 \text{ million} \\ \text{Gain to Charles Publishing's shareholders:} & \$300 \text{ million in synergies} - 200 \text{ million premium} = \$100 \text{ milli} \end{array}$$

Question 6
L2CF-PQ2719-1410
LOS: LOS-7730
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium
An acquirer is *most likely* to push a stock offering as opposed to a cash offering if:

- ○ It strongly believes that the merger will create value.
- ○ Its stock price is considered undervalued.
- ● It has high levels of financial leverage.

Rationale

This Answer is Correct

An acquirer will likely push for a **cash** offering if it strongly believes that the merger will create value.

An acquirer will push for a stock offering if its shares are considered **overvalued**.

If the acquirer already has high financial leverage, he would find it difficult to raise the necessary cash for a cash offer, and would therefore lean toward a stock offering.

Question 7
L2CF-PQ2714-1410
LOS: LOS-7690
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium

Consider the following statements:

Statement 1: In a consolidation, the previously-existing legal entities cease to exist.

Statement 2: A merger where the target hails from an industry that is completely unrelated to that of the acquirer is known as a statutory merger.

Which of the following is *most likely*?

- (selected) Only Statement 1 is correct.
- Only Statement 2 is correct.
- Both statements are incorrect.

Rationale

This Answer is Correct

Statement 1 is correct.

A merger where the target hails from an industry that is completely unrelated to that of the acquirer is known as a **conglomerate** merger.

Question 8
L2R28TB-AC010-1512
LOS: LOS-7700
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
A merger is completed between two companies which both have several earnings and performance measures that are below industry averages. Senior management teams from both firms are retained in the combined entity. The *most likely* motive for this merger is:

- (selected) managerialism.
- bootstrapped earnings.
- unlocking hidden value.

Rationale
managerialism. (correct)
Managerialism is a motive when managers hope to retain their jobs while increasing the size of the firm. When two subpar firms merge, it is likely that managers are hoping to maintain or increase their salaries at the expense of shareholders.

Rationale
bootstrapped earnings. (incorrect)
Managerialism is a motive when managers hope to retain their jobs while increasing the size of the firm. When two subpar firms merge, it is likely that managers are hoping to maintain or increase their salaries at the expense of shareholders.

Rationale
unlocking hidden value. (incorrect)
Managerialism is a motive when managers hope to retain their jobs while increasing the size of the firm. When two subpar firms merge, it is likely that managers are hoping to maintain or increase their salaries at the expense of shareholders.

Question 9
L2R28TB-AC017-1512
LOS: LOS-7820
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium
Thomas Shirt Factory (TSF) has a plant that manufactures belts only. TSF creates a new firm with the name Thomas Belts and issues shares to investors in the market to fund an expansion. This transaction is *most likely* a(n):

- ○ spin-off.
- ○ liquidation.
- ● equity carve-out.

Rationale

✗ spin-off.

Equity carve-outs occur when a firm sells new securities to investors for ownership in a new firm. In this case, Thomas could sell the entire Thomas Belts to new shareholders, or it could retain a portion of the ownership for itself.

Rationale

✗ liquidation.

Equity carve-outs occur when a firm sells new securities to investors for ownership in a new firm. In this case, Thomas could sell the entire Thomas Belts to new shareholders, or it could retain a portion of the ownership for itself.

Rationale

✓ equity carve-out.

Equity carve-outs occur when a firm sells new securities to investors for ownership in a new firm. In this case, Thomas could sell the entire Thomas Belts to new shareholders, or it could retain a portion of the ownership for itself.

Question 10
L2R28TB-AC025-1512
LOS: LOS-7750
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
An industry has an HHI value of 1,750 before a proposed merger between the third and fifth largest firms. After the merger, the HHI will increase to 1,900. The *most likely* result will be that the post-merger concentration will be:

- (selected) high and there is a high chance of government challenge.
- high and there is a moderate chance of government challenge.
- moderate and there is a high chance of government challenge.

Rationale
✔ **high and there is a high chance of government challenge.**
An HHI greater than 1,800 is an indication of high concentration. When a merger causes the HHI to rise above 1,800, the most likely government action is a challenge.

Rationale
✘ **high and there is a moderate chance of government challenge.**
An HHI greater than 1,800 is an indication of high concentration. When a merger causes the HHI to rise above 1,800, the most likely government action is a challenge.

Rationale
✘ **moderate and there is a high chance of government challenge.**
An HHI greater than 1,800 is an indication of high concentration. When a merger causes the HHI to rise above 1,800, the most likely government action is a challenge.

Question 11
L2R28TB-AC026-1512
LOS: LOS-7770
Lesson Reference: Lesson 2: Target Company Valuation
Difficulty: medium

An analyst has projected the following year one information ($ billions) for a company:

Net income	33
Net interest after tax	6
Change in deferred taxes	3
Depreciation expense	8
Increase in net working capital (NWC)	4
Capital expenditures	9

Given the above information, the year one free cash flow is *closest* to:

- (selected) $37
- $46
- $50

Rationale

✔ **$37**

The calculation of free cash flow is as follows:

	Year 1
Net income	33
+ Net after-tax interest	6
+ Change in deferred taxes	3
+ Noncash charges (depreciation)	8
− Change in net working capital	4
− Capital expenditures	9
Free cash flow	37

Rationale

✖ **$46**

The calculation of free cash flow is as follows:

	Year 1
Net income	33
+ Net after-tax interest	6
+ Change in deferred taxes	3
+ Noncash charges (depreciation)	8
− Change in net working capital	4
− Capital expenditures	9
Free cash flow	37

Rationale

$50

The calculation of free cash flow is as follows:

	Year 1
Net income	33
+ Net after-tax interest	6
+ Change in deferred taxes	3
+ Noncash charges (depreciation)	8
− Change in net working capital	4
− Capital expenditures	9
Free cash flow	37

Question 12

L2R28TB-AC014-1512

LOS: LOS-7700

Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation

Difficulty: medium

Madison Cosmetics has decided to sell its eyeliner unit because it has more expertise in skin foundation products. The *most likely* motive for the sale is:

- (selected) poor fit.
- reverse vertical integration.
- an increase in cash flow needs.

Rationale

✅ **poor fit.**

A lack of skills in certain areas is a motivating factor for a firm to divest itself of a division or business segment. This sale will allow it to focus on its core business and areas of expertise.

Rationale

❌ **reverse vertical integration.**

A lack of skills in certain areas is a motivating factor for a firm to divest itself of a division or business segment. This sale will allow it to focus on its core business and areas of expertise.

Rationale

❌ **an increase in cash flow needs.**

A lack of skills in certain areas is a motivating factor for a firm to divest itself of a division or business segment. This sale will allow it to focus on its core business and areas of expertise.

Question 13
L2R28TB-AC011-1512
LOS: LOS-7700
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
A U.S.-based landscaping firm acquires a Canadian rock quarry in an all-cash transaction. The cost of labor is much lower in Canada than in the U.S. The *most likely* motive for this merger is:

- ○ transfer of technology.
- ○ product differentiation.
- ◉ exploiting market imperfections.

Rationale
✗ **transfer of technology.**
The search for lower input costs makes a cross border merger attractive. This is especially true when there are savings in labor costs without any reduction in productivity.

Rationale
✗ **product differentiation.**
The search for lower input costs makes a cross border merger attractive. This is especially true when there are savings in labor costs without any reduction in productivity.

Rationale
✓ **exploiting market imperfections.**
The search for lower input costs makes a cross border merger attractive. This is especially true when there are savings in labor costs without any reduction in productivity.

Question 14
L2R28TB-AC018-1512
LOS: LOS-7810
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium
Which of the following merger transactions is *most likely* to create value?

- ○ Cotton's stock price falls after an all-equity takeover of a profitable furniture distributor.
- ◉ Jupiter uses an all-cash offer for a horizontal acquisition using its available free cash flows.
- ○ Spin acquires a firm citing potential synergies as motivation, while paying a premium that is 10 percent higher than similar mergers.

Rationale
❌ **Cotton's stock price falls after an all-equity takeover of a profitable furniture distributor.**
Mergers that create value are those made by strong buyers, which would include a firm that has generated enough free cash flow to be used in an acquisition.

Rationale
✅ **Jupiter uses an all-cash offer for a horizontal acquisition using its available free cash flows.**
Mergers that create value are those made by strong buyers, which would include a firm that has generated enough free cash flow to be used in an acquisition.

Rationale
❌ **Spin acquires a firm citing potential synergies as motivation, while paying a premium that is 10 percent higher than similar mergers.**
Mergers that create value are those made by strong buyers, which would include a firm that has generated enough free cash flow to be used in an acquisition.

Question 15
L2R28TB-AC012-1512
LOS: LOS-7740
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
The board of directors of Jones Piping Company has given its shareholders the right to buy Jones' shares at a substantial discount only if an acquiring firm purchases at least 5.0 percent of its outstanding shares. Jones Piping is *most likely* using a:

- (•) poison pill defense.
- ( ) fair price amendment.
- ( ) staggered board provision.

Rationale
✓ **poison pill defense.**
Poison pills give shareholders the right to buy shares when an acquiring firm passes a certain threshold of ownership, sometimes as little as 5.0 percent but possibly as much as 15.0 percent. In the proxy statement, this defense is typically called a shareholder's rights plan to disguise its true antitakeover nature. It discourages a takeover because the acquiring firm is prevented from participating in the discounted purchase, so essentially the 5.0 percent ownership it has amassed becomes worth much less.

Rationale
✗ **fair price amendment.**
Poison pills give shareholders the right to buy shares when an acquiring firm passes a certain threshold of ownership, sometimes as little as 5.0 percent but possibly as much as 15.0 percent. In the proxy statement, this defense is typically called a shareholder's rights plan to disguise its true antitakeover nature. It discourages a takeover because the acquiring firm is prevented from participating in the discounted purchase, so essentially the 5.0 percent ownership it has amassed becomes worth much less.

Rationale
✗ **staggered board provision.**
Poison pills give shareholders the right to buy shares when an acquiring firm passes a certain threshold of ownership, sometimes as little as 5.0 percent but possibly as much as 15.0 percent. In the proxy statement, this defense is typically called a shareholder's rights plan to disguise its true antitakeover nature. It discourages a takeover because the acquiring firm is prevented from participating in the discounted purchase, so essentially the 5.0 percent ownership it has amassed becomes worth much less.

Question 16
L2CF-TB0018-1412
LOS: LOS-7710
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
The bootstrap effect can occur when:

- ○ A company with a high PE acquires a company with a low PE for cash.
- ◉ A company with a high PE acquires a company with a low PE for shares.
- ○ A company with a low PE acquires a company with a high PE for cash.

Rationale
This Answer is Correct
The bootstrap effect occurs when the shares of the acquirer trade at a higher PE ratio than those of the target and the acquirer's PE does not decline following the merger announcement. This must be done using a share transaction since the boost in EPS of the postmerger company comes from the fact that the acquiring company does not need to issue as many shares per dollar of earnings in the target company as currently exist in the target company due to the differences in PE ratios.

Question 17
L2CF-TB0017-1412
LOS: LOS-7690
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Nelove Corp. is a designer and manufacturer of consumer electronics. After a recent increase in revenues and market share, the company is looking to increase its standing in the industry and make acquisitions. A candidate for acquisition that is being considered is Legg holdings, a manufacturer of a key semiconductor component that is designed into practically all of the products of Nelove. This acquisition would *most likely* be classified as:

- ○ Horizontal.
- ◉ Vertical backward integration.
- ○ Vertical forward integration.

Rationale

This Answer is Correct

This is a vertical merger because Nelove is acquiring a company in the same production chain. It is a backward integration merger since they will be purchasing a supplier to the firm. A forward integration merger would be an acquisition of a customer of Nelove such as a distributor or retailer of the product. A horizontal merger is an acquisition of a competitor.

Question 18
L2R28TB-AC008-1512
LOS: LOS-7690
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Clear Auto Part Supplies merging with Midwestern Home Builders is *most likely* an example of a:

- ○ vertical merger.
- ○ horizontal merger.
- ● conglomerate merger.

Rationale
✗ **vertical merger.**
When two unrelated firms, such as ones in the auto supplies industry and the home construction industry, merge it is known as a conglomerate merger.

Rationale
✗ **horizontal merger.**
When two unrelated firms, such as ones in the auto supplies industry and the home construction industry, merge it is known as a conglomerate merger.

Rationale
✓ **conglomerate merger.**
When two unrelated firms, such as ones in the auto supplies industry and the home construction industry, merge it is known as a conglomerate merger.

Question 19

L2CF-TBX106-1502

LOS: LOS-7750

Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation

Difficulty: easy

An industry currently consists of 20 roughly equally sized companies. Using the Herfindahl-Hirschman Index measure, what would be the *most likely* government reaction should two firms in the sector attempt to merge?

- (selected) No action.
- Possible challenge.
- Challenge.

Rationale

This Answer is Correct

Prior to the proposed merger, each company has an approximate share of 5%.

The Herfindahl-Hirschman Index (HHI) is the sum of the squares of market values. Post proposed merger, this would be:

$$10^2 + (18 \times 5^2) = 550.$$

For a postmerger HHI of less than 1,000, the government will most likely take no action, since the resulting industry is not considered to be concentrated.

Question 20
L2R28TB-AC015-1512
LOS: LOS-7720
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
A Scottish financial firm serving high net worth clients, many of whom live in the United States, has grown significantly in recent years. A merger with a regional U.S. financial institution is *most likely* motivated by a desire to:

- (selected) follow clients.
- experience a transfer of technology.
- overcome an adverse government policy.

Rationale
✔ follow clients.
Cross border mergers and acquisitions can occur for each of the reasons listed, but when a Scottish firm merges with a U.S. firm because it has many high net worth U.S. clients, the likely reason is for the Scottish firm to be able to serve its international clients as best it can.

Rationale
✖ experience a transfer of technology.
Cross border mergers and acquisitions can occur for each of the reasons listed, but when a Scottish firm merges with a U.S. firm because it has many high net worth U.S. clients, the likely reason is for the Scottish firm to be able to serve its international clients as best it can.

Rationale
✖ overcome an adverse government policy.
Cross border mergers and acquisitions can occur for each of the reasons listed, but when a Scottish firm merges with a U.S. firm because it has many high net worth U.S. clients, the likely reason is for the Scottish firm to be able to serve its international clients as best it can.

Question 21

L2CF-PQ2715-1410

LOS: LOS-7690

Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation

Difficulty: medium

Conglomerate mergers are *least likely* to be seen in which stage of the industry life cycle?

- ○ Pioneering development phase
- ○ Rapid accelerating growth phase
- ◉ Stabilization and market maturity phase

Rationale

This Answer is Correct

See Table 1-1: Mergers and the Industry Life Cycle in the Study Guide.

Question 22
L2CF-PQ2718-1410
LOS: LOS-7730
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Which of the following is *least likely* regarding an acquisition where the acquirer purchases the target's assets?

- (selected) The acquirer can use the target's tax loss carry-forwards to reduce its own tax liability.
- The target company is liable for taxes on sales of assets.
- The acquirer can purchase assets selectively.

Rationale

This Answer is Correct

In an asset purchase, the acquirer **cannot** use the target's tax loss carry-forwards to reduce its own tax liability.

Question 23

L2R28TB-AC019-1512

LOS: LOS-7800

Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring

Difficulty: medium

The clear winners in the majority of mergers are:

- ○ target managers.
- ◉ target shareholders.
- ○ acquiring firm shareholders.

Rationale

✗ **target managers.**

With takeover premiums reaching an average of about 30 percent and sometimes going as high as 50 percent, the target shareholders typically win during an acquisition. Target managers can easily lose their jobs and oftentimes acquiring firm shareholders lose because the acquirer pays too high a premium or synergies are never realized.

Rationale

✓ **target shareholders.**

With takeover premiums reaching an average of about 30 percent and sometimes going as high as 50 percent, the target shareholders typically win during an acquisition. Target managers can easily lose their jobs and oftentimes acquiring firm shareholders lose because the acquirer pays too high a premium or synergies are never realized.

Rationale

✗ **acquiring firm shareholders.**

With takeover premiums reaching an average of about 30 percent and sometimes going as high as 50 percent, the target shareholders typically win during an acquisition. Target managers can easily lose their jobs and oftentimes acquiring firm shareholders lose because the acquirer pays too high a premium or synergies are never realized.

Question 24
L2R28TB-ITEMSET-AC001-1512
LOS: LOS-7720
LOS: LOS-7700
LOS: LOS-7790
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium

Use the following information to answer the next three questions:

Pure Gold Rings is a jeweler that is pursuing a takeover of Graham Mining Company. Pure Gold has been growing rapidly over the past five years because of its ability to generate high free cash flows. Pure Gold believes it can manage commodity price risk much more efficiently with the takeover of Graham Mining. The two firms have been privately negotiating the transaction and appear to be headed toward a subsidiary merger. Graham Mining's pre-announcement stock price is $62.41.

Pure Gold is using comparative transaction analysis and has compiled the following data:

Target Firm	Takeover Premium
Little Gold	36 percent
Potter Jeweler Supply	29 percent
Big Land Mining	31 percent

i.
The merger would *most likely* be characterized as:
- horizontal.
- consolidation.
- (selected) backward integration.

Rationale
This Answer is Correct
Backward integration occurs when a firm merges with another that is closer to the origin of the value chain. A jeweler buying a mining company will remove much of the uncertainty surrounding input prices in the future, as the mining company will provide a reliable supply to the jeweler.

Rationale
This Answer is Correct
Backward integration occurs when a firm merges with another that is closer to the origin of the value chain. A jeweler buying a mining company will remove much of the uncertainty surrounding input prices in the future, as the mining company will provide a reliable supply to the jeweler.

Rationale
This Answer is Correct
Backward integration occurs when a firm merges with another that is closer to the origin of the value chain. A jeweler buying a mining company will remove much of the uncertainty surrounding input prices in the future, as the mining company will provide a reliable supply to the jeweler.

ii.

The *most likely* motive for this merger is:

- [x] synergies.
- [ ] diversification.
- [ ] increase in market power.

Rationale

This Answer is Incorrect

There are probably economies of scale that will be achieved with this merger, as the jeweler will likely experience a reduction in procurement costs and possibly distribution and administration costs.

Rationale

This Answer is Incorrect

There are probably economies of scale that will be achieved with this merger, as the jeweler will likely experience a reduction in procurement costs and possibly distribution and administration costs.

Rationale

This Answer is Incorrect

There are probably economies of scale that will be achieved with this merger, as the jeweler will likely experience a reduction in procurement costs and possibly distribution and administration costs.

iii.

Which of the following is *closest to* the takeover bid price?

- [ ] \$80.51
- [x] \$82.38
- [ ] \$84.87

Rationale

This Answer is Incorrect

Based on the three previous takeovers, an average takeover premium of 32 percent is observed. This premium is then applied to the Graham Mining's current stock to find the *most likely* takeover bid price:

$$\$62.41 \times (1 + 0.32) = \$82.38$$

Rationale

This Answer is Incorrect

Based on the three previous takeovers, an average takeover premium of 32 percent is observed. This premium is then applied to the Graham Mining's current stock to find the *most likely* takeover bid price:

$$\$62.41 \times (1 + 0.32) = \$82.38$$

Rationale

This Answer is Incorrect

Based on the three previous takeovers, an average takeover premium of 32 percent is observed. This premium is then applied to the Graham Mining's current stock to find the *most likely* takeover bid price:

$$\$62.41 \times (1 + 0.32) = \$82.38$$

Question 25
L2CF-ITEMSET-TBB201-1412
LOS: LOS-7790
LOS: LOS-7800
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring

The next four questions are based on the following information:

Dibvig Industrial Tools Inc. and Buyme Corp. are negotiating a friendly acquisition of Buyme by Dibvig. Three alternative offers are being considered:

1. Cash offer of $4 per share of Buyme Corp. stock.
2. Stock offer of 0.3 shares of Dibvig per share of Buyme Corp. stock.
3. Mixed offer of $2 plus 0.15 shares of Dibvig per share of Buyme Corp. stock.

It is estimated that the merger of the two companies will result in synergies with a net present value of $50 million. Other relevant information is displayed below:

	Dibvig	**Buyme**
Premerger stock price	$13.50	$3.00
Number of shares outstanding (millions)	100	20

i.
The gain to shareholders of Buyme under the cash offer is closest to:
- $10 million.
- $20 million.
- $40 million.

Rationale
This Answer is Correct

Target shareholders' gain = Premium = price paid – premerger value of the target company; hence, under the cash offer:

Target shareholders' gain = ($4 × 20 million) – ($3 million × 20 million) = $20 million.

ii.
The gain to Dibvig under the stock offer is closest to:
- $20 million.
- $21 million.
- $27 million.

Rationale
This Answer is Correct

Target shareholders' gain = premium = price paid – premerger value of the target company. For a stock deal the dilution from the issuance of extra shares needs to be considered.

The postmerger value of the combined company will equal the sum of the premerger values of the two companies plus synergies minus cash consideration paid. In this case, this will be:

Postmerger value of the company = ($13.50 × 100m) + ($3 × 20m) + $50m = $1,460 million.

Dibvig will have to issue 0.3 shares for every Buyme share, which will mean issuing 0.3 × 20 million = 6 million new shares.

Hence, the postmerger value of Dibvig shares will be $1,460 / (100 + 6) = $13.77.

Hence, Target shareholders' gain = ($13.77 × 0.3 × 20 million) – ($3 million × 20 million) = $22.64 million.

Then acquirer's gain = Synergies – Premium = $50 million – $22.64 million = $27.36 million.

iii.

Which offer should the board of Buyme attempt to negotiate?

- ( ) Cash.
- (•) Stock.
- ( ) Mixed.

Rationale

This Answer is Correct

Buyme should negotiate the offer that maximizes the gain to their shareholders. Under the cash offer the gain is $20 million. Under the stock offer, the gain is $22.64 million. Since the mixed offer is a combination of these two deals, the gains to target shareholders will be in between these two values.

iv.

If the management of Dibvig has low confidence that the estimated synergies will actually be realized, which offer should they attempt to negotiate?

- ( ) Cash.
- (•) Stock.
- ( ) Mixed.

Rationale

This Answer is Correct

The more confident the managers are that the estimated synergies will be realized, the more the acquiring managers will prefer to pay with cash and the more the target shareholders will want to receive stock.

Question 26
L2R28TB-AC013-1512
LOS: LOS-7750
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
A firm has revenue of $4.8 million in an industry with an HHI value of 900. This firm merges with another firm and the result is a change in the HHI to 950. The *most likely* government response is:

- no response.
- possible challenge to the merger.
- definite antitrust lawsuit against the merger.

Rationale
no response.
Industries with HHI values that are under 1,000 after a merger are not likely to garner much interest from government agencies.

Rationale
possible challenge to the merger.
Industries with HHI values that are under 1,000 after a merger are not likely to garner much interest from government agencies.

Rationale
definite antitrust lawsuit against the merger.
Industries with HHI values that are under 1,000 after a merger are not likely to garner much interest from government agencies.

Question 27
L2R28TB-AC009-1512
LOS: LOS-7700
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Two regional financial institutions complete a consolidation and realize both cost reductions and revenue enhancements. The *most likely* motive for this merger is:

- (selected) synergies.
- diversification.
- increase in market power.

Rationale
✔ **synergies.**
Common merger synergies include economies of scale in production, which will reduce costs, and enhancements in revenues, which may be due to greater efficiencies in advertising and marketing.

Rationale
✖ **diversification.**
Common merger synergies include economies of scale in production, which will reduce costs, and enhancements in revenues, which may be due to greater efficiencies in advertising and marketing.

Rationale
✖ **increase in market power.**
Common merger synergies include economies of scale in production, which will reduce costs, and enhancements in revenues, which may be due to greater efficiencies in advertising and marketing.

Question 28
L2CF-ITEMSET-PQ2703-1411
LOS: LOS-7603
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium

Use the following information to answer the next two questions:

An analyst gathered the following information regarding an industry with 10 competitors:

Company	1	2	3	4	5	6	7	8	9	10
Market share (%)	30	15	15	10	7	7	6	4	3	3

i.
The Herfindahl-Hirschman Index for the industry is *closest to*:

- (selected) 1,618
- 0.1618
- 29.59

Rationale

This Answer is Correct

Herfindahl-Hirschman Index

Company	**Market Share (%)**	**Squared Market Share**
1	30	900
2	15	225
3	15	225
4	10	100
5	7	49
6	7	49
7	6	36
8	4	16
9	3	9
10	3	9
HHI		**1,618**

ii.

Consider the following statements:

Statement 1: A merger between Companies 5 and 6 will not lead to any government action.
Statement 2: A merger between Companies 7 and 8 will not lead to any government action.

Which of the following is *most likely*?

- Only Statement 1 is incorrect.
- Only Statement 2 is incorrect.
- (selected) Both statements are correct.

Rationale

This Answer is Correct

Post-Merger Companies 5 and 6			Post-Merger Companies 7 and 8		
Company	**Market Share (%)**	**Squared Market Share**	**Company**	**Market Share (%)**	**Squared Market Share**
1	30	900	1	30	900
2	15	225	2	15	225
3	15	225	3	15	225
4	10	100	4	10	100
5 + 6	14	196	5	7	49
7	6	36	6	7	49
8	4	16	7 + 8	10	100
9	3	9	9	3	9
10	3	9	10	3	9
HHI		**1,716**	**HHI**		**1,666**

The industry's HHI initially lay between 1,000 and 1,800 so it was moderately concentrated. Since the change in HHI in both cases is less than 100, there will be no government action against either of the mergers.

Question 29

L2CF-TB0021-1412

LOS: LOS-7720

Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation

Difficulty: medium

When comparing a stock purchase verses an asset purchase, which of the following statements is *most likely* to be accurate?

- The target company will be liable for tax under a stock purchase but not under an asset purchase.
- (selected) The target company shareholders will be liable for tax under a stock purchase but not under an asset purchase.
- The target company shareholders will be liable for tax under both a stock purchase and an asset purchase.

Rationale

This Answer is Correct

Asset purchases will give rise to taxes on capital gains for the target company. Stock purchases will give rise to taxes on capital gains for target company shareholders.

Question 30
L2CF-TB0022-1412
LOS: LOS-7730
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Which of the following mechanisms is least likely to be a form of preoffer takeover defense by a target company?

- ○ Poison pills.
- ○ “Dead-hand” provision.
- ◉ White knight defense.

Rationale

This Answer is Correct

Poison pills grant rights to target company shareholders to purchase shares at a deeply discounted price, which will reduce the attractiveness of any hostile bid. The authority to cancel these rights being vested only in continuing directors (i.e., those that were in place prior to the takeover bid) is called a dead-hand provision. The white knight defense is a postoffer takeover defense where the target company seeks a friendly third party to purchase the target company in lieu of the hostile bidder.

Question 31
L2R28TB-AC023-1512
LOS: LOS-7770
Lesson Reference: Lesson 2: Target Company Valuation
Difficulty: medium
An acquiring firm is using free cash flow to estimate the takeover value for Table Inc. Table's current free cash flow is $15 million and it is expected to grow by 25 percent for each of the next three years. After three years of high growth, Table's growth is expected to slow to 5.0 percent annually. If the relevant discount rate is 12.5 percent, then the undiscounted, end of year three terminal value is *closest* to:

- (selected) $410 million.
- $390 million.
- $246 million.

Rationale
✔ **$410 million.**

First, find the projected cash flows for year four:

$$\$15 \text{ million} \times (1.25)^3 \times (1.05) = \$30.76 \text{ million}$$

The end of year three terminal value is then calculated as follows:

$$\text{TV}_T = \frac{\text{FCF}_T \times (1+\text{g})}{\text{WACC} - \text{g}} = \frac{\$30.76 \text{ million}}{0.125 - 0.05} = \$410 \text{ million}$$

Rationale
✖ **$390 million.**

First, find the projected cash flows for year four:

$$\$15 \text{ million} \times (1.25)^3 \times (1.05) = \$30.76 \text{ million}$$

The end of year three terminal value is then calculated as follows:

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Rationale
✖ **$246 million.**

First, find the projected cash flows for year four:

$$\$15 \text{ million} \times (1.25)^3 \times (1.05) = \$30.76 \text{ million}$$

The end of year three terminal value is then calculated as follows:

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Question 32
L2CF-ITEMSET-PQ2711-1411
LOS: LOS-7607
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium

Use the following information to answer the next two questions:

Gemco Ltd is considering a friendly acquisition of Tintin Investments for a stock offer of 0.8 shares of Gemco per share of Tintin. Gemco's management estimates that the merger will create synergies worth $270 million. The following information is provided:

	Gemco Ltd	Tintin Investments
Pre-merger stock price ($)	27	15
Number of shares outstanding (millions)	75	30

i.
The total value paid by Gemco to Tintin's shareholders is *closest to*:
- $648 million
- $665 million (selected)
- $878 million

Rationale
This Answer is Correct

Post-merger value of the combined company = $V_{A^*} = V_A + V_T + S - C$

V_{A^*} = ($27 × 75m) + ($15 × 30m) + $270m = $2,745 million

Number of shares to be issued by Gemco = 0.8 × 30m = 24 million

Post-merger stock price = $2,745m / (75m + 24m) = $27.7273 per share

Total value paid to Tintin = $27.7273 × 24m = $665.4552 million

ii.
The acquirer's gain is *closest to*:
- $55 million (selected)
- $72 million
- -$158 million

Rationale
This Answer is Correct

Takeover premium = $P_T - V_T$

Takeover premium = $665.4552m − ($15 × 30m) = $215.4552 million

Acquirer’s gain = Synergies − Premium

Acquirer’s gain = $270m − $215.4552m = $54.5448 million

Question 33
L2R28TB-AC024-1512
LOS: LOS-7770
Lesson Reference: Lesson 2: Target Company Valuation
Difficulty: medium

In estimating free cash flows for a target firm, an acquirer expects the following (in millions):

> Year 1: An increase in net working capital of $10 and capital expenditures of $15.
> Year 2: An increase in net working capital of $8 and sale of equipment of $13.

The effect of these working capital and capital equipment items on the total free cash flow will be:

- (selected) Year 1 cash flow falls and Year 2 cash flow rises as a result of these items.
- Year 1 cash flow falls and Year 2 cash flow falls as a result of these items.
- Year 1 cash flow rises and Year 2 cash flow falls as a result of these items.

Rationale
✔ **Year 1 cash flow falls and Year 2 cash flow rises as a result of these items.**
Both the increase in net working capital and the capital expenditures are cash outflows and this will reduce total free cash flows. In year two, however, the asset sale exceeds the working capital expenditure and the resulting net effect of the two is an increase in total cash flows.

Rationale
✖ **Year 1 cash flow falls and Year 2 cash flow falls as a result of these items.**
Both the increase in net working capital and the capital expenditures are cash outflows and this will reduce total free cash flows. In year two, however, the asset sale exceeds the working capital expenditure and the resulting net effect of the two is an increase in total cash flows.

Rationale
✖ **Year 1 cash flow rises and Year 2 cash flow falls as a result of these items.**
Both the increase in net working capital and the capital expenditures are cash outflows and this will reduce total free cash flows. In year two, however, the asset sale exceeds the working capital expenditure and the resulting net effect of the two is an increase in total cash flows.

Question 34
L2CF-PQ2716-1410
LOS: LOS-7690
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Vertical mergers are *most* likely to be seen in which stage of the industry life cycle?

- ○ Pioneering development phase
- ◉ Mature growth phase
- ○ Stabilization and market maturity phase

Rationale

This Answer is Correct

See Table 1-1: Mergers and the Industry Life Cycle in the Study Guide.

Question 35
L2CF-TBX107-1502
LOS: LOS-7820
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: easy
A company wishing to raise capital through a restructuring may consider enacting:

- (selected) An equity carve-out.
- A spin-off.
- A split-off.

Rationale

This Answer is Correct

In an equity carve-out, new shares in a separate legal entity representing a division of the parent company are created and sold to outsiders, hence generating capital. No capital is raised either in a spin-off, where existing shareholders are allocated shares in two companies where there used to be one, or a split-off where existing shareholders receive shares in a new company in exchange for some shares in the parent company.

Question 36
L2R28TB-AC007-1512
LOS: LOS-7690
Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation
Difficulty: medium
Duke Door Company merges with National Windows. Duke absorbs all of National's assets and liabilities in its financial statements. If National ceases to exist, this control change event is *most likely* a:

- ○ consolidation.
- ◉ statutory merger.
- ○ subsidiary merger.

Rationale
✗ **consolidation.**
Statutory mergers occur when the target company ceases to exist and becomes wholly owned by the acquiring firm.

Rationale
✓ **statutory merger.**
Statutory mergers occur when the target company ceases to exist and becomes wholly owned by the acquiring firm.

Rationale
✗ **subsidiary merger.**
Statutory mergers occur when the target company ceases to exist and becomes wholly owned by the acquiring firm.

Question 37
L2R28TB-AC021-1512
LOS: LOS-7760
Lesson Reference: Lesson 2: Target Company Valuation
Difficulty: medium
A large firm has used comparable transaction analysis in past successful takeovers of three firms. It will use the identical analysis in its bid for Moon Balls, a unique firm with a single patented product line. The *most likely* problem facing this acquiring firm is:

- ○ difficulty in estimating the target's intrinsic value.
- ○ a poor estimate for changes in Moon Balls' capital structure.
- ● data from related industries might not be relevant or accurate.

Rationale
✗ **difficulty in estimating the target's intrinsic value.**
With only one unique product line, using comparable transaction analysis will increase the uncertainty surrounding the data collected for comparison. The data will likely not be relevant or accurate.

Rationale
✗ **a poor estimate for changes in Moon Balls' capital structure.**
With only one unique product line, using comparable transaction analysis will increase the uncertainty surrounding the data collected for comparison. The data will likely not be relevant or accurate.

Rationale
✓ **data from related industries might not be relevant or accurate.**
With only one unique product line, using comparable transaction analysis will increase the uncertainty surrounding the data collected for comparison. The data will likely not be relevant or accurate.

Question 38
L2R28TB-AC022-1512
LOS: LOS-7760
Lesson Reference: Lesson 2: Target Company Valuation
Difficulty: medium
Healthy Hospital Supply (HHS) uses the discounted cash flow method in setting the price for a competitor it takes over. If HHS underestimates the target's risk level, the *most likely* result will be a terminal value calculation that is:

- too low.
- too high.
- accurate.

Rationale
too low.
Not gauging the risk level accurately will lead to the use of a discount rate that is too low, resulting again in a terminal value that is too high.

Rationale
too high.
Not gauging the risk level accurately will lead to the use of a discount rate that is too low, resulting again in a terminal value that is too high.

Rationale
accurate.
Not gauging the risk level accurately will lead to the use of a discount rate that is too low, resulting again in a terminal value that is too high.

Question 39
L2CF-TBX108-1502
LOS: LOS-7830
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: easy
Which of the following situations is *least likely* to be a reason for a company to consider a divestiture?

- ○ Reverse synergies.
- ○ Emergency cash flow needs.
- ● Cash flow needed for expansion.

Rationale

This Answer is Correct

A divestiture is a restructuring whereby a company sells or splits off operating assets in order to get smaller. Common reasons for a restructuring include a change in strategic focus, a poor fit of a division with the rest of the firm, reverse synergies from breaking up the company into separate firms, or cash flow need in tough times.

Question 40
L2CF-ITEMSET-PQ2708-1411
LOS: LOS-7607
Lesson Reference: Lesson 3: Bid Evaluation and Corporate Restructuring
Difficulty: medium

Use the following information to answer the next three questions:

Pinnacle Inc. is considering a friendly acquisition of Censure Industries for a cash offer that values the company at 20% higher than its current market capitalization. Pinnacle's management estimates that the merger will create synergies worth $220 million. The following information is provided:

	Pinnacle Inc.	**Censure Industries**
Pre-merger stock price ($)	38	22
Number of shares outstanding (millions)	90	35

i.
The takeover premium is *closest to*:

- (selected) $154 million
- $924 million
- $770 million

Rationale
This Answer is Correct

Takeover premium = $P_T - V_T$

Cash offer per share = $22 × 1.20 = $26.40

Total purchase price = $26.40 × 35 million = $924 million

Takeover premium = $924m − ($22 × 35m) = $154 million

ii.
The post-merger value of the combined company is *closest to*:

- $4,410 million
- $3,266 million
- (selected) $3,486 million

Rationale
This Answer is Correct

$V_{A^*} = V_A + V_T + S - C$

V_{A^*} = ($38 × 90m) + ($22 × 35m) + $220m − ($26.4 × 35m) = $3,486 million

iii.
The acquirer's gain is *closest to*:

- $2,716 million

- [x] $66 million
- [ ] $2,650 million

Rationale

This Answer is Correct

Acquirer’s gain = Synergies − Takeover premium

Acquirer’s gain = $220m − $154m = $66 million

Question 41

L2CF-TB0020-1412

LOS: LOS-7720

Lesson Reference: Lesson 1: Mergers and Acquisitions: Definitions, Classifications, Motives, Transaction Characteristics, and Regulation

Difficulty: medium

Vertical mergers are more likely to occur in which of the following stages of the industry life cycle?

- ○ Pioneering development.
- ◉ Mature growth.
- ○ Rapid accelerating growth.

Rationale

This Answer is Correct

Vertical mergers are most likely to occur when companies are trying to achieve economies of scale, savings, and operational efficiencies. This is most likely to be the case in the mature growth phase of the industry life cycle. During the pioneering development and rapid accelerating growth phases, mergers are more likely to be horizontal and conglomerate as small rapidly growing companies merge with larger companies or competitors looking to acquire growth.