Chapter 13

Equity Valuation

**Multiple Choice Questions**

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| 1. | The accounting measure of a firm's equity value generated by applying accounting principles to asset and liability acquisitions is called \_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | book value |  |  |  | | --- | --- | | B. | market value |  |  |  | | --- | --- | | C. | liquidation value |  |  |  | | --- | --- | | D. | Tobin's *q* | |

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| 2. | The price-to-sales ratio is probably most useful for firms in which phase of the industry life cycle?      |  |  | | --- | --- | | A. | Start-up phase |  |  |  | | --- | --- | | B. | Consolidation |  |  |  | | --- | --- | | C. | Maturity |  |  |  | | --- | --- | | D. | Relative decline | |

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| 3. | If a firm increases its plowback ratio, this will probably result in \_\_\_\_\_\_\_ P/E ratio.      |  |  | | --- | --- | | A. | a higher |  |  |  | | --- | --- | | B. | a lower |  |  |  | | --- | --- | | C. | an unchanged |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| 4. | The value of Internet companies is based primarily on \_\_\_\_\_.      |  |  | | --- | --- | | A. | current profits |  |  |  | | --- | --- | | B. | Tobin's *q* |  |  |  | | --- | --- | | C. | growth opportunities |  |  |  | | --- | --- | | D. | replacement cost | |

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| 5. | New-economy companies generally have higher \_\_\_\_\_\_\_ than old-economy companies.      |  |  | | --- | --- | | A. | book value per share |  |  |  | | --- | --- | | B. | P/E multiples |  |  |  | | --- | --- | | C. | profits |  |  |  | | --- | --- | | D. | asset values | |

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| 6. | P/E ratios tend to be \_\_\_\_\_\_\_ when inflation is \_\_\_\_\_\_.      |  |  | | --- | --- | | A. | higher; higher |  |  |  | | --- | --- | | B. | lower; lower |  |  |  | | --- | --- | | C. | higher; lower |  |  |  | | --- | --- | | D. | They are unrelated. | |

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| 7. | Which one of the following statements about market and book value is correct?      |  |  | | --- | --- | | A. | All firms sell at a market-to-book ratio above 1. |  |  |  | | --- | --- | | B. | All firms sell at a market-to-book ratio greater than or equal to 1. |  |  |  | | --- | --- | | C. | All firms sell at a market-to-book ratio below 1. |  |  |  | | --- | --- | | D. | Most firms have a market-to-book ratio above 1, but not all. | |

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| 8. | Earnings yields tend to \_\_\_\_\_\_\_ when Treasury yields fall.      |  |  | | --- | --- | | A. | fall |  |  |  | | --- | --- | | B. | rise |  |  |  | | --- | --- | | C. | remain unchanged |  |  |  | | --- | --- | | D. | fluctuate wildly | |

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| 9. | Which one of the following is a common term for the market consensus value of the required return on a stock?      |  |  | | --- | --- | | A. | Dividend payout ratio |  |  |  | | --- | --- | | B. | Intrinsic value |  |  |  | | --- | --- | | C. | Market capitalization rate |  |  |  | | --- | --- | | D. | Plowback ratio | |

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| 10. | Which one of the following is equal to the ratio of common shareholders' equity to common shares outstanding?      |  |  | | --- | --- | | A. | Book value per share |  |  |  | | --- | --- | | B. | Liquidation value per share |  |  |  | | --- | --- | | C. | Market value per share |  |  |  | | --- | --- | | D. | Tobin's *q* | |

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| 11. | A firm has current assets that could be sold for their book value of $10 million. The book value of its fixed assets is $60 million, but they could be sold for $95 million today. The firm has total debt at a book value of $40 million, but interest rate changes have increased the value of the debt to a current market value of $50 million. This firm's market-to-book ratio is \_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 1.83 |  |  |  | | --- | --- | | B. | 1.5 |  |  |  | | --- | --- | | C. | 1.35 |  |  |  | | --- | --- | | D. | 1.46 | |

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| 12. | If a stock is correctly priced, then you know that \_\_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | the dividend payout ratio is optimal |  |  |  | | --- | --- | | B. | the stock's required return is equal to the growth rate in earnings and dividends |  |  |  | | --- | --- | | C. | the sum of the stock's expected capital gain and dividend yield is equal to the stock's required rate of return |  |  |  | | --- | --- | | D. | the present value of growth opportunities is equal to the value of assets in place | |

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| 13. | A stock has an intrinsic value of $15 and an actual stock price of $13.50. You know that this stock \_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | has a Tobin's *q* value < 1 |  |  |  | | --- | --- | | B. | will generate a positive alpha |  |  |  | | --- | --- | | C. | has an expected return less than its required return |  |  |  | | --- | --- | | D. | has a beta > 1 | |

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| 14. | Bill, Jim, and Shelly are all interested in buying the same stock that pays dividends. Bill plans on holding the stock for 1 year. Jim plans on holding the stock for 3 years. Shelly plans on holding the stock until she retires in 10 years. Which one of the following statements is correct?      |  |  | | --- | --- | | A. | Bill will be willing to pay the most for the stock because he will get his money back in 1 year when he sells. |  |  |  | | --- | --- | | B. | Jim should be willing to pay three times as much for the stock as Bill will pay because his expected holding period is three times as long as Bill's. |  |  |  | | --- | --- | | C. | Shelly should be willing to pay the most for the stock because she will hold it the longest and hence will get the most dividends. |  |  |  | | --- | --- | | D. | All three should be willing to pay the same amount for the stock regardless of their holding period. | |

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| 15. | A firm that has an ROE of 12% is considering cutting its dividend payout. The stockholders of the firm desire a dividend yield of 4% and a capital gain yield of 9%. Given this information, which of the following statements is (are) correct?  I. All else equal, the firm's growth rate will accelerate after the payout change. II. All else equal, the firm's stock price will go up after the payout change. III. All else equal, the firm's P/E ratio will increase after the payout change.      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | II and III only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| 16. | A firm cuts its dividend payout ratio. As a result, you know that the firm's \_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | return on assets will increase |  |  |  | | --- | --- | | B. | earnings retention ratio will increase |  |  |  | | --- | --- | | C. | earnings growth rate will fall |  |  |  | | --- | --- | | D. | stock price will fall | |

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| 17. | \_\_\_\_\_\_\_\_\_\_ is the amount of money per common share that could be realized by breaking up the firm, selling its assets, repaying its debt, and distributing the remainder to shareholders.      |  |  | | --- | --- | | A. | Book value per share |  |  |  | | --- | --- | | B. | Liquidation value per share |  |  |  | | --- | --- | | C. | Market value per share |  |  |  | | --- | --- | | D. | Tobin's *q* | |

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| 18. | An underpriced stock provides an expected return that is \_\_\_\_\_\_\_\_\_\_\_\_ the required return based on the capital asset pricing model (CAPM).      |  |  | | --- | --- | | A. | less than |  |  |  | | --- | --- | | B. | equal to |  |  |  | | --- | --- | | C. | greater than |  |  |  | | --- | --- | | D. | greater than or equal to | |

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| 19. | Stockholders of Dogs R Us Pet Supply expect a 12% rate of return on their stock. Management has consistently been generating an ROE of 15% over the last 5 years but now believes that ROE will be 12% for the next 5 years. Given this, the firm's optimal dividend payout ratio is now \_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 0% |  |  |  | | --- | --- | | B. | 100% |  |  |  | | --- | --- | | C. | between 0% and 50% |  |  |  | | --- | --- | | D. | between 50% and 100% | |

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| 20. | The constant-growth dividend discount model (DDM) can be used only when the \_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | growth rate is less than or equal to the required return |  |  |  | | --- | --- | | B. | growth rate is greater than or equal to the required return |  |  |  | | --- | --- | | C. | growth rate is less than the required return |  |  |  | | --- | --- | | D. | growth rate is greater than the required return | |

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| 21. | Suppose that in 2012 the expected dividends of the stocks in a broad market index equaled $240 million when the discount rate was 8% and the expected growth rate of the dividends equaled 6%. Using the constant-growth formula for valuation, if interest rates increase to 9%, the value of the market will change by \_\_\_\_\_.      |  |  | | --- | --- | | A. | -10% |  |  |  | | --- | --- | | B. | -20% |  |  |  | | --- | --- | | C. | -25% |  |  |  | | --- | --- | | D. | -33% | |

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| 22. | You want to earn a return of 10% on each of two stocks, A and B. Each of the stocks is expected to pay a dividend of $4 in the upcoming year. The expected growth rate of dividends is 6% for stock A and 5% for stock B. Using the constant-growth DDM, the intrinsic value of stock A \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | will be higher than the intrinsic value of stock B |  |  |  | | --- | --- | | B. | will be the same as the intrinsic value of stock B |  |  |  | | --- | --- | | C. | will be less than the intrinsic value of stock B |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| 23. | Each of two stocks, A and B, is expected to pay a dividend of $7 in the upcoming year. The expected growth rate of dividends is 6% for both stocks. You require a return of 10% on stock A and a return of 12% on stock B. Using the constant-growth DDM, the intrinsic value of stock A \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | will be higher than the intrinsic value of stock B |  |  |  | | --- | --- | | B. | will be the same as the intrinsic value of stock B |  |  |  | | --- | --- | | C. | will be less than the intrinsic value of stock B |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| 24. | You want to earn a return of 11% on each of two stocks, A and B. Stock A is expected to pay a dividend of $3 in the upcoming year, while stock B is expected to pay a dividend of $2 in the upcoming year. The expected growth rate of dividends for both stocks is 4%. Using the constant-growth DDM, the intrinsic value of stock A \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | will be higher than the intrinsic value of stock B |  |  |  | | --- | --- | | B. | will be the same as the intrinsic value of stock B |  |  |  | | --- | --- | | C. | will be less than the intrinsic value of stock B |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| 25. | You are considering acquiring a common share of Sahali Shopping Center Corporation that you would like to hold for 1 year. You expect to receive both $1.25 in dividends and $35 from the sale of the share at the end of the year. The maximum price you would pay for a share today is \_\_\_\_\_\_\_\_\_\_ if you wanted to earn a 12% return.      |  |  | | --- | --- | | A. | $31.25 |  |  |  | | --- | --- | | B. | $32.37 |  |  |  | | --- | --- | | C. | $38.47 |  |  |  | | --- | --- | | D. | $41.32 | |

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| 26. | The market capitalization rate on the stock of Aberdeen Wholesale Company is 10%. Its expected ROE is 12%, and its expected EPS is $5. If the firm's plowback ratio is 50%, its P/E ratio will be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 8.33 |  |  |  | | --- | --- | | B. | 12.5 |  |  |  | | --- | --- | | C. | 19.23 |  |  |  | | --- | --- | | D. | 24.15 | |

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| 27. | The market capitalization rate on the stock of Aberdeen Wholesale Company is 10%. Its expected ROE is 12%, and its expected EPS is $5. If the firm's plowback ratio is 60%, its P/E ratio will be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 7.14 |  |  |  | | --- | --- | | B. | 14.29 |  |  |  | | --- | --- | | C. | 16.67 |  |  |  | | --- | --- | | D. | 22.22 | |

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| 28. | Weyerhaeuser Incorporated has a balance sheet that lists $70 million in assets, $45 million in liabilities, and $25 million in common shareholders' equity. It has 1 million common shares outstanding. The replacement cost of its assets is $85 million. Its share price in the market is $49. Its book value per share is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $16.67 |  |  |  | | --- | --- | | B. | $25 |  |  |  | | --- | --- | | C. | $37.50 |  |  |  | | --- | --- | | D. | $40.83 | |

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| 29. | Eagle Brand Arrowheads has expected earnings of $1.25 per share and a market capitalization rate of 12%. Earnings are expected to grow at 5% per year indefinitely. The firm has a 40% plowback ratio. By how much does the firm's ROE exceed the market capitalization rate?      |  |  | | --- | --- | | A. | .5% |  |  |  | | --- | --- | | B. | 1% |  |  |  | | --- | --- | | C. | 1.5% |  |  |  | | --- | --- | | D. | 2% | |

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| 30. | Gagliardi Way Corporation has an expected ROE of 15%. If it pays out 30% of its earnings as dividends, its dividend growth rate will be \_\_\_\_\_.      |  |  | | --- | --- | | A. | 4.5% |  |  |  | | --- | --- | | B. | 10.5% |  |  |  | | --- | --- | | C. | 15% |  |  |  | | --- | --- | | D. | 30% | |

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| 31. | A preferred share of Coquihalla Corporation will pay a dividend of $8 in the upcoming year and every year thereafter; that is, dividends are not expected to grow. You require a return of 7% on this stock. Using the constant-growth DDM to calculate the intrinsic value, a preferred share of Coquihalla Corporation is worth \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $13.50 |  |  |  | | --- | --- | | B. | $45.50 |  |  |  | | --- | --- | | C. | $91 |  |  |  | | --- | --- | | D. | $114.29 | |

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| 32. | Brevik Builders has an expected ROE of 25%. Its dividend growth rate will be \_\_\_\_\_\_\_\_\_\_ if it follows a policy of paying 30% of earnings in the form of dividends.      |  |  | | --- | --- | | A. | 5% |  |  |  | | --- | --- | | B. | 15% |  |  |  | | --- | --- | | C. | 17.5% |  |  |  | | --- | --- | | D. | 45% | |

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| 33. | A firm is planning on paying its first dividend of $2 three years from today. After that, dividends are expected to grow at 6% per year indefinitely. The stock's required return is 14%. What is the intrinsic value of a share today?      |  |  | | --- | --- | | A. | $25 |  |  |  | | --- | --- | | B. | $16.87 |  |  |  | | --- | --- | | C. | $19.24 |  |  |  | | --- | --- | | D. | $20.99 | |

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| 34. | Rose Hill Trading Company is expected to have EPS in the upcoming year of $8. The expected ROE is 18%. An appropriate required return on the stock is 14%. If the firm has a plowback ratio of 70%, its dividend in the upcoming year should be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $1.12 |  |  |  | | --- | --- | | B. | $1.44 |  |  |  | | --- | --- | | C. | $2.40 |  |  |  | | --- | --- | | D. | $5.60 | |

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| 35. | Rose Hill Trading Company is expected to have EPS in the upcoming year of $6. The expected ROE is 18%. An appropriate required return on the stock is 14%. If the firm has a plowback ratio of 70%, its intrinsic value should be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $20.93 |  |  |  | | --- | --- | | B. | $69.77 |  |  |  | | --- | --- | | C. | $128.57 |  |  |  | | --- | --- | | D. | $150 | |

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| 36. | Cache Creek Manufacturing Company is expected to pay a dividend of $3.36 in the upcoming year. Dividends are expected to grow at 8% per year. The risk-free rate of return is 4%, and the expected return on the market portfolio is 14%. Investors use the CAPM to compute the market capitalization rate and use the constant-growth DDM to determine the value of the stock. The stock's current price is $84. Using the constant-growth DDM, the market capitalization rate is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 9% |  |  |  | | --- | --- | | B. | 12% |  |  |  | | --- | --- | | C. | 14% |  |  |  | | --- | --- | | D. | 18% | |

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| 37. | Grott and Perrin, Inc., has expected earnings of $3 per share for next year. The firm's ROE is 20%, and its earnings retention ratio is 70%. If the firm's market capitalization rate is 15%, what is the present value of its growth opportunities?      |  |  | | --- | --- | | A. | $20 |  |  |  | | --- | --- | | B. | $70 |  |  |  | | --- | --- | | C. | $90 |  |  |  | | --- | --- | | D. | $115 | |

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| 38. | Ace Ventura, Inc., has expected earnings of $5 per share for next year. The firm's ROE is 15%, and its earnings retention ratio is 40%. If the firm's market capitalization rate is 10%, what is the present value of its growth opportunities?      |  |  | | --- | --- | | A. | $25 |  |  |  | | --- | --- | | B. | $50 |  |  |  | | --- | --- | | C. | $75 |  |  |  | | --- | --- | | D. | $100 | |

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| 39. | Annie's Donut Shops, Inc., has expected earnings of $3 per share for next year. The firm's ROE is 18%, and its earnings retention ratio is 60%. If the firm's market capitalization rate is 12%, what is the value of the firm excluding any growth opportunities?      |  |  | | --- | --- | | A. | $25 |  |  |  | | --- | --- | | B. | $50 |  |  |  | | --- | --- | | C. | $83.33 |  |  |  | | --- | --- | | D. | $208 | |

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| 40. | Flanders, Inc., has expected earnings of $4 per share for next year. The firm's ROE is 8%, and its earnings retention ratio is 40%. If the firm's market capitalization rate is 15%, what is the present value of its growth opportunities?      |  |  | | --- | --- | | A. | -$6.33 |  |  |  | | --- | --- | | B. | $0 |  |  |  | | --- | --- | | C. | $20.34 |  |  |  | | --- | --- | | D. | $26.67 | |

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| 41. | Firm A is high-risk, and Firm B is low-risk. Everything else equal, which firm would you expect to have a higher P/E ratio?      |  |  | | --- | --- | | A. | Firm A |  |  |  | | --- | --- | | B. | Firm B |  |  |  | | --- | --- | | C. | Both would have the same P/E if they were in the same industry. |  |  |  | | --- | --- | | D. | There is not necessarily any linkage between risk and P/E ratios. | |

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| 42. | Firms with higher expected growth rates tend to have P/E ratios that are \_\_\_\_\_\_\_\_\_\_\_ the P/E ratios of firms with lower expected growth rates.      |  |  | | --- | --- | | A. | higher than |  |  |  | | --- | --- | | B. | equal to |  |  |  | | --- | --- | | C. | lower than |  |  |  | | --- | --- | | D. | There is not necessarily any linkage between risk and P/E ratios. | |

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| 43. | Value stocks are more likely to have a PEG ratio \_\_\_\_\_.      |  |  | | --- | --- | | A. | less than 1 |  |  |  | | --- | --- | | B. | equal to 1 |  |  |  | | --- | --- | | C. | greater than 1 |  |  |  | | --- | --- | | D. | less than zero | |

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| 44. | Generally speaking, as a firm progresses through the industry life cycle, you would expect the PVGO to \_\_\_\_\_\_\_\_ as a percentage of share price.      |  |  | | --- | --- | | A. | increase |  |  |  | | --- | --- | | B. | decrease |  |  |  | | --- | --- | | C. | stay the same |  |  |  | | --- | --- | | D. | No typical pattern can be expected. | |

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| 45. | Cache Creek Manufacturing Company is expected to pay a dividend of $4.20 in the upcoming year. Dividends are expected to grow at the rate of 8% per year. The risk-free rate of return is 4%, and the expected return on the market portfolio is 14%. Investors use the CAPM to compute the market capitalization rate on the stock and use the constant-growth DDM to determine the intrinsic value of the stock. The stock is trading in the market today at $84. Using the constant-growth DDM and the CAPM, the beta of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 1.4 |  |  |  | | --- | --- | | B. | .9 |  |  |  | | --- | --- | | C. | .8 |  |  |  | | --- | --- | | D. | .5 | |

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| 46. | Westsyde Tool Company is expected to pay a dividend of $1.50 in the upcoming year. The risk-free rate of return is 6%, and the expected return on the market portfolio is 14%. Analysts expect the price of Westsyde Tool Company shares to be $29 a year from now. The beta of Westsyde Tool Company's stock is 1.2. Using the CAPM, an appropriate required return on Westsyde Tool Company's stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 8% |  |  |  | | --- | --- | | B. | 10.8% |  |  |  | | --- | --- | | C. | 15.6% |  |  |  | | --- | --- | | D. | 16.8% | |

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| 47. | Westsyde Tool Company is expected to pay a dividend of $2 in the upcoming year. The risk-free rate of return is 6%, and the expected return on the market portfolio is 12%. Analysts expect the price of Westsyde Tool Company shares to be $29 a year from now. The beta of Westsyde Tool Company's stock is 1.2. Using a one-period valuation model, the intrinsic value of Westsyde Tool Company stock today is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $24.29 |  |  |  | | --- | --- | | B. | $27.39 |  |  |  | | --- | --- | | C. | $31.13 |  |  |  | | --- | --- | | D. | $34.52 | |

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| 48. | Todd Mountain Development Corporation is expected to pay a dividend of $2.50 in the upcoming year. Dividends are expected to grow at the rate of 8% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 12%. The stock of Todd Mountain Development Corporation has a beta of .75. Using the CAPM, the return you should require on the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 7.25% |  |  |  | | --- | --- | | B. | 10.25% |  |  |  | | --- | --- | | C. | 14.75% |  |  |  | | --- | --- | | D. | 21% | |

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| 49. | Todd Mountain Development Corporation is expected to pay a dividend of $3 in the upcoming year. Dividends are expected to grow at the rate of 8% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 17%. The stock of Todd Mountain Development Corporation has a beta of .75. Using the constant-growth DDM, the intrinsic value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 4 |  |  |  | | --- | --- | | B. | 17.65 |  |  |  | | --- | --- | | C. | 37.50 |  |  |  | | --- | --- | | D. | 50 | |

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| 50. | Generally speaking, the higher a firm's ROA, the \_\_\_\_\_\_\_\_\_ the dividend payout ratio and the \_\_\_\_\_\_\_\_\_ the firm's growth rate of earnings.      |  |  | | --- | --- | | A. | higher; lower |  |  |  | | --- | --- | | B. | higher; higher |  |  |  | | --- | --- | | C. | lower; lower |  |  |  | | --- | --- | | D. | lower; higher | |

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| 51. | Interior Airline is expected to pay a dividend of $3 in the upcoming year. Dividends are expected to grow at the rate of 10% per year. The risk-free rate of return is 4%, and the expected return on the market portfolio is 13%. The stock of Interior Airline has a beta of 4. Using the constant-growth DDM, the intrinsic value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $10 |  |  |  | | --- | --- | | B. | $22.73 |  |  |  | | --- | --- | | C. | $27.78 |  |  |  | | --- | --- | | D. | $41.67 | |

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| 52. | Caribou Gold Mining Corporation is expected to pay a dividend of $4 in the upcoming year. Dividends are expected to decline at the rate of 3% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 13%. The stock of Caribou Gold Mining Corporation has a beta of .5. Using the CAPM, the return you should require on the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 2% |  |  |  | | --- | --- | | B. | 5% |  |  |  | | --- | --- | | C. | 8% |  |  |  | | --- | --- | | D. | 9% | |

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| 53. | Caribou Gold Mining Corporation is expected to pay a dividend of $6 in the upcoming year. Dividends are expected to decline at the rate of 3% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 13%. The stock of Caribou Gold Mining Corporation has a beta of .5. Using the constant-growth DDM, the intrinsic value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $50 |  |  |  | | --- | --- | | B. | $100 |  |  |  | | --- | --- | | C. | $150 |  |  |  | | --- | --- | | D. | $200 | |

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| 54. | Lifecycle Motorcycle Company is expected to pay a dividend in year 1 of $2, a dividend in year 2 of $3, and a dividend in year 3 of $4. After year 3, dividends are expected to grow at the rate of 7% per year. An appropriate required return for the stock is 12%. Using the multistage DDM, the stock should be worth \_\_\_\_\_\_\_\_\_\_ today.      |  |  | | --- | --- | | A. | $63.80 |  |  |  | | --- | --- | | B. | $65.13 |  |  |  | | --- | --- | | C. | $67.95 |  |  |  | | --- | --- | | D. | $85.60 | |

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| 55. | Ace Frisbee Corporation produces a good that is very mature in the firm's product life cycles. Ace Frisbee Corporation is expected to pay a dividend in year 1 of $3, a dividend in year 2 of $2, and a dividend in year 3 of $1. After year 3, dividends are expected to decline at the rate of 2% per year. An appropriate required return for the stock is 8%. Using the multistage DDM, the stock should be worth \_\_\_\_\_\_\_\_\_\_ today.      |  |  | | --- | --- | | A. | $13.07 |  |  |  | | --- | --- | | B. | $13.58 |  |  |  | | --- | --- | | C. | $18.25 |  |  |  | | --- | --- | | D. | $18.78 | |

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| 56. | A firm's earnings per share increased from $10 to $12, its dividends increased from $4 to $4.40, and its share price increased from $80 to $100. Given this information, it follows that \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | the stock experienced a drop in its P/E ratio |  |  |  | | --- | --- | | B. | the company had a decrease in its dividend payout ratio |  |  |  | | --- | --- | | C. | both earnings and share price increased by 20% |  |  |  | | --- | --- | | D. | the required rate of return increased | |

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| 57. | Assuming all other factors remain unchanged, \_\_\_\_\_\_\_\_\_\_ would increase a firm's price-earnings ratio.      |  |  | | --- | --- | | A. | an increase in the dividend payout ratio |  |  |  | | --- | --- | | B. | a reduction in investor risk aversion |  |  |  | | --- | --- | | C. | an expected increase in the level of inflation |  |  |  | | --- | --- | | D. | an increase in the yield on Treasury bills | |

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| 58. | A company with an expected earnings growth rate which is greater than that of the typical company in the same industry most likely has \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | a dividend yield which is greater than that of the typical company |  |  |  | | --- | --- | | B. | a dividend yield which is less than that of the typical company |  |  |  | | --- | --- | | C. | less risk than the typical company |  |  |  | | --- | --- | | D. | less sensitivity to market trends than the typical company | |

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| 59. | Everything else equal, which variable is negatively related to the intrinsic value of a company?      |  |  | | --- | --- | | A. | *D*1 |  |  |  | | --- | --- | | B. | *D*0 |  |  |  | | --- | --- | | C. | *g* |  |  |  | | --- | --- | | D. | *k* | |

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| 60. | Sanders, Inc., paid a $4 dividend per share last year and is expected to continue to pay out 60% of its earnings as dividends for the foreseeable future. If the firm is expected to generate a 13% return on equity in the future, and if you require a 15% return on the stock, the value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $26.67 |  |  |  | | --- | --- | | B. | $35.19 |  |  |  | | --- | --- | | C. | $42.94 |  |  |  | | --- | --- | | D. | $59.89 | |

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| 61. | A firm has PVGO of 0 and a market capitalization rate of 12%. What is the firm's P/E ratio?      |  |  | | --- | --- | | A. | 12 |  |  |  | | --- | --- | | B. | 8.33 |  |  |  | | --- | --- | | C. | 10.25 |  |  |  | | --- | --- | | D. | 18.55 | |

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| 62. | A firm has an earnings retention ratio of 40%. The stock has a market capitalization rate of 15% and an ROE of 18%. What is the stock's P/E ratio?      |  |  | | --- | --- | | A. | 12.82 |  |  |  | | --- | --- | | B. | 7.69 |  |  |  | | --- | --- | | C. | 8.33 |  |  |  | | --- | --- | | D. | 9.46 | |

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| 63. | A common stock pays an annual dividend per share of $1.80. The risk-free rate is 5%, and the risk premium for this stock is 4%. If the annual dividend is expected to remain at $1.80 per share, what is the value of the stock?      |  |  | | --- | --- | | A. | $17.78 |  |  |  | | --- | --- | | B. | $20 |  |  |  | | --- | --- | | C. | $40 |  |  |  | | --- | --- | | D. | None of these options | |

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| 64. | Transportation stocks currently provide an expected rate of return of 15%. TTT, a large transportation company, will pay a year-end dividend of $3 per share. If the stock is selling at $60 per share, what must be the market's expectation of the constant-growth rate of TTT dividends?      |  |  | | --- | --- | | A. | 5% |  |  |  | | --- | --- | | B. | 10% |  |  |  | | --- | --- | | C. | 20% |  |  |  | | --- | --- | | D. | None of these options | |

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| 65. | A stock is priced at $45 per share. The stock has earnings per share of $3 and a market capitalization rate of 14%. What is the stock's PVGO?      |  |  | | --- | --- | | A. | $23.57 |  |  |  | | --- | --- | | B. | $15 |  |  |  | | --- | --- | | C. | $19.78 |  |  |  | | --- | --- | | D. | $21.34 | |

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| 66. | A firm increases its dividend plowback ratio. All else equal, you know that \_\_\_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | earnings growth will increase and the stock's P/E will increase |  |  |  | | --- | --- | | B. | earnings growth will decrease and the stock's P/E will increase |  |  |  | | --- | --- | | C. | earnings growth will increase and the stock's P/E will decrease |  |  |  | | --- | --- | | D. | earnings growth will increase and the stock's P/E may or may not increase | |

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| 67. | A firm has a stock price of $54.75 per share. The firm's earnings are $75 million, and the firm has 20 million shares outstanding. The firm has an ROE of 15% and a plowback of 65%. What is the firm's PEG ratio?      |  |  | | --- | --- | | A. | 1.5 |  |  |  | | --- | --- | | B. | 1.25 |  |  |  | | --- | --- | | C. | 1.1 |  |  |  | | --- | --- | | D. | 1 | |

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| 68. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  At what price would you expect ART to sell?      |  |  | | --- | --- | | A. | $25 |  |  |  | | --- | --- | | B. | $34.29 |  |  |  | | --- | --- | | C. | $42.86 |  |  |  | | --- | --- | | D. | $45.67 | |

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| 69. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  At what P/E ratio would you expect ART to sell?      |  |  | | --- | --- | | A. | 8.33 |  |  |  | | --- | --- | | B. | 11.43 |  |  |  | | --- | --- | | C. | 14.29 |  |  |  | | --- | --- | | D. | 15.25 | |

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| 70. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  What is the present value of growth opportunities for ART?      |  |  | | --- | --- | | A. | $8.57 |  |  |  | | --- | --- | | B. | $9.29 |  |  |  | | --- | --- | | C. | $14.29 |  |  |  | | --- | --- | | D. | $16.29 | |

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| 71. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  What price do you expect ART shares to sell for in 4 years?      |  |  | | --- | --- | | A. | $53.96 |  |  |  | | --- | --- | | B. | $44.95 |  |  |  | | --- | --- | | C. | $41.68 |  |  |  | | --- | --- | | D. | $39.76 | |

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| 72. | The EBIT of a firm is $300, the tax rate is 35%, the depreciation is $20, capital expenditures are $60, and the increase in net working capital is $30. What is the free cash flow to the firm?      |  |  | | --- | --- | | A. | $85 |  |  |  | | --- | --- | | B. | $125 |  |  |  | | --- | --- | | C. | $185 |  |  |  | | --- | --- | | D. | $305 | |

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| 73. | A firm reports EBIT of $100 million. The income statement shows depreciation of $20 million. If the tax rate is 35% and total capital expenditures and increases in working capital total $10 million, what is the free cash flow to the firm?      |  |  | | --- | --- | | A. | $57 |  |  |  | | --- | --- | | B. | $65 |  |  |  | | --- | --- | | C. | $75 |  |  |  | | --- | --- | | D. | $95 | |

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| 74. | The free cash flow to the firm is $300 million in perpetuity, the cost of equity equals 14%, and the WACC is 10%. If the market value of the debt is $1 billion, what is the value of the equity using the free cash flow valuation approach?      |  |  | | --- | --- | | A. | $1 billion |  |  |  | | --- | --- | | B. | $2 billion |  |  |  | | --- | --- | | C. | $3 billion |  |  |  | | --- | --- | | D. | $4 billion | |

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| 75. | If a firm has a free cash flow equal to $50 million and that cash flow is expected to grow at 3% forever, what is the total firm value given a WACC of 9.5%?      |  |  | | --- | --- | | A. | $679.81 million |  |  |  | | --- | --- | | B. | $715.54 million |  |  |  | | --- | --- | | C. | $769.23 million |  |  |  | | --- | --- | | D. | $803.03 million | |

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| 76. | The free cash flow to the firm is reported as $405 million. The interest expense to the firm is $76 million. If the tax rate is 35% and the net debt of the firm increased by $50 million, what is the free cash flow to the equity holders of the firm?      |  |  | | --- | --- | | A. | $405.6 million |  |  |  | | --- | --- | | B. | $454.2 million |  |  |  | | --- | --- | | C. | $505.8 million |  |  |  | | --- | --- | | D. | $553.5 million | |

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| 77. | The free cash flow to the firm is reported as $275 million. The interest expense to the firm is $60 million. If the tax rate is 35% and the net debt of the firm increased by $33 million, what is the free cash flow to the equity holders of the firm?      |  |  | | --- | --- | | A. | $269 million |  |  |  | | --- | --- | | B. | $296 million |  |  |  | | --- | --- | | C. | $305 million |  |  |  | | --- | --- | | D. | $327 million | |

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| 78. | The free cash flow to the firm is reported as $205 million. The interest expense to the firm is $22 million. If the tax rate is 35% and the net debt of the firm increased by $25 million, what is the approximate market value of the firm if the FCFE grows at 2% and the cost of equity is 11%?      |  |  | | --- | --- | | A. | $2,168 billion |  |  |  | | --- | --- | | B. | $2,445 billion |  |  |  | | --- | --- | | C. | $2,565 billion |  |  |  | | --- | --- | | D. | $2,998 billion | |

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| 79. | The free cash flow to the firm is reported as $198 million. The interest expense to the firm is $15 million. If the tax rate is 35% and the net debt of the firm increased by $20 million, what is the approximate market value of the firm if the FCFE grows at 3% and the cost of equity is 14%?      |  |  | | --- | --- | | A. | $1,950 billion |  |  |  | | --- | --- | | B. | $2,497 billion |  |  |  | | --- | --- | | C. | $2,585 billion |  |  |  | | --- | --- | | D. | $3,098 billion | |

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| 80. | Firm A has a stock price of $35, and 60% of the value of the stock is in the form of PVGO. Firm B also has a stock price of $35, but only 20% of the value of stock B is in the form of PVGO. We know that:  I. Stock A will give us a higher return than Stock B. II. An investment in stock A is probably riskier than an investment in stock B. III. Stock A has higher forecast earnings growth than stock B.      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | II and III only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| 81. | A firm is expected to produce earnings next year of $3 per share. It plans to reinvest 25% of its earnings at 20%. If the cost of equity is 11%, what should be the value of the stock?      |  |  | | --- | --- | | A. | $27.27 |  |  |  | | --- | --- | | B. | $37.50 |  |  |  | | --- | --- | | C. | $66.67 |  |  |  | | --- | --- | | D. | $70 | |

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| 82. | Next year's earnings are estimated to be $5. The company plans to reinvest 20% of its earnings at 15%. If the cost of equity is 9%, what is the present value of growth opportunities?      |  |  | | --- | --- | | A. | $9.09 |  |  |  | | --- | --- | | B. | $10.10 |  |  |  | | --- | --- | | C. | $11.11 |  |  |  | | --- | --- | | D. | $12.21 | |

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| 83. | Next year's earnings are estimated to be $6. The company plans to reinvest 33% of its earnings at 12%. If the cost of equity is 8%, what is the present value of growth opportunities?      |  |  | | --- | --- | | A. | $6 |  |  |  | | --- | --- | | B. | $24.50 |  |  |  | | --- | --- | | C. | $44.44 |  |  |  | | --- | --- | | D. | $75 | |

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| 84. | When Google's share price reached $475 per share, Google had a P/E ratio of about 68 and an estimated market capitalization rate of 11.5%. Google pays no dividends. Approximately what percentage of Google's stock price was represented by PVGO?      |  |  | | --- | --- | | A. | 92% |  |  |  | | --- | --- | | B. | 87% |  |  |  | | --- | --- | | C. | 77% |  |  |  | | --- | --- | | D. | 64% | |

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| 85. | A firm has a stock price of $55 per share and a P/E ratio of 75. If you buy the stock at this P/E and earnings fail to grow at all, how long should you expect it to take to just recover the cost of your investment?      |  |  | | --- | --- | | A. | 27 years |  |  |  | | --- | --- | | B. | 37 years |  |  |  | | --- | --- | | C. | 55 years |  |  |  | | --- | --- | | D. | 75 years | |

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| 86. | In what industry are investors likely to use the dividend discount model and arrive at a price close to the observed market price?      |  |  | | --- | --- | | A. | Import/export trade |  |  |  | | --- | --- | | B. | Software |  |  |  | | --- | --- | | C. | Telecommunications |  |  |  | | --- | --- | | D. | Utility | |

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| 87. | Estimates of a stock's intrinsic value calculated with the free cash flow methodology depend most critically on \_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | the terminal value used |  |  |  | | --- | --- | | B. | whether one uses FCFF or FCFE |  |  |  | | --- | --- | | C. | the time period used to estimate the cash flows |  |  |  | | --- | --- | | D. | whether the firm is currently paying dividends | |

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| 88. | The greatest value to an analyst from calculating a stock's intrinsic value is \_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | how easy it is to come up with accurate model inputs |  |  |  | | --- | --- | | B. | the precision of the value estimate |  |  |  | | --- | --- | | C. | how the process forces analysts to understand the critical variables that have the greatest impact on value |  |  |  | | --- | --- | | D. | how all the different models typically yield identical value results | |

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| 89. | Which of the following valuation measures is often used to compare firms that have no earnings?      |  |  | | --- | --- | | A. | Price-to-book ratio |  |  |  | | --- | --- | | B. | P/E ratio |  |  |  | | --- | --- | | C. | Price-to-cash-flow ratio |  |  |  | | --- | --- | | D. | Price-to-sales ratio | |

Chapter 13 Equity Valuation Answer Key

**Multiple Choice Questions**

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1. | The accounting measure of a firm's equity value generated by applying accounting principles to asset and liability acquisitions is called \_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | book value |  |  |  | | --- | --- | | B. | market value |  |  |  | | --- | --- | | C. | liquidation value |  |  |  | | --- | --- | | D. | Tobin's *q* | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-01 Use financial statements and market comparables to estimate firm value. Topic: Valuation by Comparables* |

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| 2. | The price-to-sales ratio is probably most useful for firms in which phase of the industry life cycle?      |  |  | | --- | --- | | **A.** | Start-up phase |  |  |  | | --- | --- | | B. | Consolidation |  |  |  | | --- | --- | | C. | Maturity |  |  |  | | --- | --- | | D. | Relative decline | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Other Comparative Valuation Ratios* |

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| 3. | If a firm increases its plowback ratio, this will probably result in \_\_\_\_\_\_\_ P/E ratio.      |  |  | | --- | --- | | A. | a higher |  |  |  | | --- | --- | | B. | a lower |  |  |  | | --- | --- | | C. | an unchanged |  |  |  | | --- | --- | | **D.** | The answer cannot be determined from the information given. | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 4. | The value of Internet companies is based primarily on \_\_\_\_\_.      |  |  | | --- | --- | | A. | current profits |  |  |  | | --- | --- | | B. | Tobin's *q* |  |  |  | | --- | --- | | **C.** | growth opportunities |  |  |  | | --- | --- | | D. | replacement cost | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 5. | New-economy companies generally have higher \_\_\_\_\_\_\_ than old-economy companies.      |  |  | | --- | --- | | A. | book value per share |  |  |  | | --- | --- | | **B.** | P/E multiples |  |  |  | | --- | --- | | C. | profits |  |  |  | | --- | --- | | D. | asset values | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 6. | P/E ratios tend to be \_\_\_\_\_\_\_ when inflation is \_\_\_\_\_\_.      |  |  | | --- | --- | | A. | higher; higher |  |  |  | | --- | --- | | B. | lower; lower |  |  |  | | --- | --- | | **C.** | higher; lower |  |  |  | | --- | --- | | D. | They are unrelated. | |

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| *AACSB: Analytic Blooms: Understand Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 7. | Which one of the following statements about market and book value is correct?      |  |  | | --- | --- | | A. | All firms sell at a market-to-book ratio above 1. |  |  |  | | --- | --- | | B. | All firms sell at a market-to-book ratio greater than or equal to 1. |  |  |  | | --- | --- | | C. | All firms sell at a market-to-book ratio below 1. |  |  |  | | --- | --- | | **D.** | Most firms have a market-to-book ratio above 1, but not all. | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-01 Use financial statements and market comparables to estimate firm value. Topic: Valuation by Comparables* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 8. | Earnings yields tend to \_\_\_\_\_\_\_ when Treasury yields fall.      |  |  | | --- | --- | | **A.** | fall |  |  |  | | --- | --- | | B. | rise |  |  |  | | --- | --- | | C. | remain unchanged |  |  |  | | --- | --- | | D. | fluctuate wildly | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Aggregate Stock Market* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 9. | Which one of the following is a common term for the market consensus value of the required return on a stock?      |  |  | | --- | --- | | A. | Dividend payout ratio |  |  |  | | --- | --- | | B. | Intrinsic value |  |  |  | | --- | --- | | **C.** | Market capitalization rate |  |  |  | | --- | --- | | D. | Plowback ratio | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 10. | Which one of the following is equal to the ratio of common shareholders' equity to common shares outstanding?      |  |  | | --- | --- | | **A.** | Book value per share |  |  |  | | --- | --- | | B. | Liquidation value per share |  |  |  | | --- | --- | | C. | Market value per share |  |  |  | | --- | --- | | D. | Tobin's *q* | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-01 Use financial statements and market comparables to estimate firm value. Topic: Valuation by Comparables* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 11. | A firm has current assets that could be sold for their book value of $10 million. The book value of its fixed assets is $60 million, but they could be sold for $95 million today. The firm has total debt at a book value of $40 million, but interest rate changes have increased the value of the debt to a current market value of $50 million. This firm's market-to-book ratio is \_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | 1.83 |  |  |  | | --- | --- | | B. | 1.5 |  |  |  | | --- | --- | | C. | 1.35 |  |  |  | | --- | --- | | D. | 1.46 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-01 Use financial statements and market comparables to estimate firm value. Topic: Valuation by Comparables* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 12. | If a stock is correctly priced, then you know that \_\_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | the dividend payout ratio is optimal |  |  |  | | --- | --- | | B. | the stock's required return is equal to the growth rate in earnings and dividends |  |  |  | | --- | --- | | **C.** | the sum of the stock's expected capital gain and dividend yield is equal to the stock's required rate of return |  |  |  | | --- | --- | | D. | the present value of growth opportunities is equal to the value of assets in place | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 13. | A stock has an intrinsic value of $15 and an actual stock price of $13.50. You know that this stock \_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | has a Tobin's *q* value < 1 |  |  |  | | --- | --- | | **B.** | will generate a positive alpha |  |  |  | | --- | --- | | C. | has an expected return less than its required return |  |  |  | | --- | --- | | D. | has a beta > 1 | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 14. | Bill, Jim, and Shelly are all interested in buying the same stock that pays dividends. Bill plans on holding the stock for 1 year. Jim plans on holding the stock for 3 years. Shelly plans on holding the stock until she retires in 10 years. Which one of the following statements is correct?      |  |  | | --- | --- | | A. | Bill will be willing to pay the most for the stock because he will get his money back in 1 year when he sells. |  |  |  | | --- | --- | | B. | Jim should be willing to pay three times as much for the stock as Bill will pay because his expected holding period is three times as long as Bill's. |  |  |  | | --- | --- | | C. | Shelly should be willing to pay the most for the stock because she will hold it the longest and hence will get the most dividends. |  |  |  | | --- | --- | | **D.** | All three should be willing to pay the same amount for the stock regardless of their holding period. | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 15. | A firm that has an ROE of 12% is considering cutting its dividend payout. The stockholders of the firm desire a dividend yield of 4% and a capital gain yield of 9%. Given this information, which of the following statements is (are) correct?  I. All else equal, the firm's growth rate will accelerate after the payout change. II. All else equal, the firm's stock price will go up after the payout change. III. All else equal, the firm's P/E ratio will increase after the payout change.      |  |  | | --- | --- | | **A.** | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | C. | II and III only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 16. | A firm cuts its dividend payout ratio. As a result, you know that the firm's \_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | return on assets will increase |  |  |  | | --- | --- | | **B.** | earnings retention ratio will increase |  |  |  | | --- | --- | | C. | earnings growth rate will fall |  |  |  | | --- | --- | | D. | stock price will fall | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 17. | \_\_\_\_\_\_\_\_\_\_ is the amount of money per common share that could be realized by breaking up the firm, selling its assets, repaying its debt, and distributing the remainder to shareholders.      |  |  | | --- | --- | | A. | Book value per share |  |  |  | | --- | --- | | **B.** | Liquidation value per share |  |  |  | | --- | --- | | C. | Market value per share |  |  |  | | --- | --- | | D. | Tobin's *q* | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-01 Use financial statements and market comparables to estimate firm value. Topic: Valuation by Comparables* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 18. | An underpriced stock provides an expected return that is \_\_\_\_\_\_\_\_\_\_\_\_ the required return based on the capital asset pricing model (CAPM).      |  |  | | --- | --- | | A. | less than |  |  |  | | --- | --- | | B. | equal to |  |  |  | | --- | --- | | **C.** | greater than |  |  |  | | --- | --- | | D. | greater than or equal to | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 19. | Stockholders of Dogs R Us Pet Supply expect a 12% rate of return on their stock. Management has consistently been generating an ROE of 15% over the last 5 years but now believes that ROE will be 12% for the next 5 years. Given this, the firm's optimal dividend payout ratio is now \_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 0% |  |  |  | | --- | --- | | **B.** | 100% |  |  |  | | --- | --- | | C. | between 0% and 50% |  |  |  | | --- | --- | | D. | between 50% and 100% | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 20. | The constant-growth dividend discount model (DDM) can be used only when the \_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | growth rate is less than or equal to the required return |  |  |  | | --- | --- | | B. | growth rate is greater than or equal to the required return |  |  |  | | --- | --- | | **C.** | growth rate is less than the required return |  |  |  | | --- | --- | | D. | growth rate is greater than the required return | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 21. | Suppose that in 2012 the expected dividends of the stocks in a broad market index equaled $240 million when the discount rate was 8% and the expected growth rate of the dividends equaled 6%. Using the constant-growth formula for valuation, if interest rates increase to 9%, the value of the market will change by \_\_\_\_\_.      |  |  | | --- | --- | | A. | -10% |  |  |  | | --- | --- | | B. | -20% |  |  |  | | --- | --- | | C. | -25% |  |  |  | | --- | --- | | **D.** | -33% | |

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| *AACSB: Reflective Thinking Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 22. | You want to earn a return of 10% on each of two stocks, A and B. Each of the stocks is expected to pay a dividend of $4 in the upcoming year. The expected growth rate of dividends is 6% for stock A and 5% for stock B. Using the constant-growth DDM, the intrinsic value of stock A \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | will be higher than the intrinsic value of stock B |  |  |  | | --- | --- | | B. | will be the same as the intrinsic value of stock B |  |  |  | | --- | --- | | C. | will be less than the intrinsic value of stock B |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| *AACSB: Reflective Thinking Blooms: Understand Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 23. | Each of two stocks, A and B, is expected to pay a dividend of $7 in the upcoming year. The expected growth rate of dividends is 6% for both stocks. You require a return of 10% on stock A and a return of 12% on stock B. Using the constant-growth DDM, the intrinsic value of stock A \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | will be higher than the intrinsic value of stock B |  |  |  | | --- | --- | | B. | will be the same as the intrinsic value of stock B |  |  |  | | --- | --- | | C. | will be less than the intrinsic value of stock B |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| *AACSB: Reflective Thinking Blooms: Understand Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 24. | You want to earn a return of 11% on each of two stocks, A and B. Stock A is expected to pay a dividend of $3 in the upcoming year, while stock B is expected to pay a dividend of $2 in the upcoming year. The expected growth rate of dividends for both stocks is 4%. Using the constant-growth DDM, the intrinsic value of stock A \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | will be higher than the intrinsic value of stock B |  |  |  | | --- | --- | | B. | will be the same as the intrinsic value of stock B |  |  |  | | --- | --- | | C. | will be less than the intrinsic value of stock B |  |  |  | | --- | --- | | D. | The answer cannot be determined from the information given. | |

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| *AACSB: Reflective Thinking Blooms: Understand Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 25. | You are considering acquiring a common share of Sahali Shopping Center Corporation that you would like to hold for 1 year. You expect to receive both $1.25 in dividends and $35 from the sale of the share at the end of the year. The maximum price you would pay for a share today is \_\_\_\_\_\_\_\_\_\_ if you wanted to earn a 12% return.      |  |  | | --- | --- | | A. | $31.25 |  |  |  | | --- | --- | | **B.** | $32.37 |  |  |  | | --- | --- | | C. | $38.47 |  |  |  | | --- | --- | | D. | $41.32 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 26. | The market capitalization rate on the stock of Aberdeen Wholesale Company is 10%. Its expected ROE is 12%, and its expected EPS is $5. If the firm's plowback ratio is 50%, its P/E ratio will be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 8.33 |  |  |  | | --- | --- | | **B.** | 12.5 |  |  |  | | --- | --- | | C. | 19.23 |  |  |  | | --- | --- | | D. | 24.15 |   Dividend payout ratio = 1 - .5 = .5 Expected dividend = .5 × $5 = $2.50 Growth rate = .5 × 12% = 6% Value = $2.50/(.10 - .06) = $62.50 P/E = $62.50/$5 = 12.5 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 27. | The market capitalization rate on the stock of Aberdeen Wholesale Company is 10%. Its expected ROE is 12%, and its expected EPS is $5. If the firm's plowback ratio is 60%, its P/E ratio will be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 7.14 |  |  |  | | --- | --- | | **B.** | 14.29 |  |  |  | | --- | --- | | C. | 16.67 |  |  |  | | --- | --- | | D. | 22.22 |   Dividend payout ratio = 1 - .46 = .4 Expected dividend = .4 × $5 = $2 Growth rate = .6 × 12% = 7.2% Value = $2/(.1 - .072) = $71.43 P/E = $71.43/$5 = 14.29 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 28. | Weyerhaeuser Incorporated has a balance sheet that lists $70 million in assets, $45 million in liabilities, and $25 million in common shareholders' equity. It has 1 million common shares outstanding. The replacement cost of its assets is $85 million. Its share price in the market is $49. Its book value per share is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $16.67 |  |  |  | | --- | --- | | **B.** | $25 |  |  |  | | --- | --- | | C. | $37.50 |  |  |  | | --- | --- | | D. | $40.83 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-01 Use financial statements and market comparables to estimate firm value. Topic: Valuation by Comparables* |

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| 29. | Eagle Brand Arrowheads has expected earnings of $1.25 per share and a market capitalization rate of 12%. Earnings are expected to grow at 5% per year indefinitely. The firm has a 40% plowback ratio. By how much does the firm's ROE exceed the market capitalization rate?      |  |  | | --- | --- | | **A.** | .5% |  |  |  | | --- | --- | | B. | 1% |  |  |  | | --- | --- | | C. | 1.5% |  |  |  | | --- | --- | | D. | 2% |   ROE = *g*/*b* = .05/.4 = 12.5%; *k* is given as 12%, so ROE - *k* = .5% |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 30. | Gagliardi Way Corporation has an expected ROE of 15%. If it pays out 30% of its earnings as dividends, its dividend growth rate will be \_\_\_\_\_.      |  |  | | --- | --- | | A. | 4.5% |  |  |  | | --- | --- | | **B.** | 10.5% |  |  |  | | --- | --- | | C. | 15% |  |  |  | | --- | --- | | D. | 30% |   *b* = 1 - .3 = .7 *g* = *b* × ROE = .7 × 15% = 10.5% |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 31. | A preferred share of Coquihalla Corporation will pay a dividend of $8 in the upcoming year and every year thereafter; that is, dividends are not expected to grow. You require a return of 7% on this stock. Using the constant-growth DDM to calculate the intrinsic value, a preferred share of Coquihalla Corporation is worth \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $13.50 |  |  |  | | --- | --- | | B. | $45.50 |  |  |  | | --- | --- | | C. | $91 |  |  |  | | --- | --- | | **D.** | $114.29 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 32. | Brevik Builders has an expected ROE of 25%. Its dividend growth rate will be \_\_\_\_\_\_\_\_\_\_ if it follows a policy of paying 30% of earnings in the form of dividends.      |  |  | | --- | --- | | A. | 5% |  |  |  | | --- | --- | | B. | 15% |  |  |  | | --- | --- | | **C.** | 17.5% |  |  |  | | --- | --- | | D. | 45% |   *g* = .25(1 - .3) = .175 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 33. | A firm is planning on paying its first dividend of $2 three years from today. After that, dividends are expected to grow at 6% per year indefinitely. The stock's required return is 14%. What is the intrinsic value of a share today?      |  |  | | --- | --- | | A. | $25 |  |  |  | | --- | --- | | B. | $16.87 |  |  |  | | --- | --- | | **C.** | $19.24 |  |  |  | | --- | --- | | D. | $20.99 |   Intrinsic value at time 2 = $2/(.14 - .06) = $25 Intrinsic value today = $25/(1.14)2 = $19.24 |

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| *AACSB: Reflective Thinking Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 34. | Rose Hill Trading Company is expected to have EPS in the upcoming year of $8. The expected ROE is 18%. An appropriate required return on the stock is 14%. If the firm has a plowback ratio of 70%, its dividend in the upcoming year should be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $1.12 |  |  |  | | --- | --- | | B. | $1.44 |  |  |  | | --- | --- | | **C.** | $2.40 |  |  |  | | --- | --- | | D. | $5.60 |   *D*1 = $8 (1 - .7) = $2.40 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 35. | Rose Hill Trading Company is expected to have EPS in the upcoming year of $6. The expected ROE is 18%. An appropriate required return on the stock is 14%. If the firm has a plowback ratio of 70%, its intrinsic value should be \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $20.93 |  |  |  | | --- | --- | | B. | $69.77 |  |  |  | | --- | --- | | **C.** | $128.57 |  |  |  | | --- | --- | | D. | $150 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 36. | Cache Creek Manufacturing Company is expected to pay a dividend of $3.36 in the upcoming year. Dividends are expected to grow at 8% per year. The risk-free rate of return is 4%, and the expected return on the market portfolio is 14%. Investors use the CAPM to compute the market capitalization rate and use the constant-growth DDM to determine the value of the stock. The stock's current price is $84. Using the constant-growth DDM, the market capitalization rate is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 9% |  |  |  | | --- | --- | | **B.** | 12% |  |  |  | | --- | --- | | C. | 14% |  |  |  | | --- | --- | | D. | 18% |   From the relationship *k* = (3.36/84) + .08 = .12 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 37. | Grott and Perrin, Inc., has expected earnings of $3 per share for next year. The firm's ROE is 20%, and its earnings retention ratio is 70%. If the firm's market capitalization rate is 15%, what is the present value of its growth opportunities?      |  |  | | --- | --- | | A. | $20 |  |  |  | | --- | --- | | **B.** | $70 |  |  |  | | --- | --- | | C. | $90 |  |  |  | | --- | --- | | D. | $115 |   Value with no growth = $3/.15 = $20 Growth rate = .7 × 20% = 14% Value with growth = $3 × (1 - .7)/(.15 - .14) = $90 PVGO = $90 - 20 = $70 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 38. | Ace Ventura, Inc., has expected earnings of $5 per share for next year. The firm's ROE is 15%, and its earnings retention ratio is 40%. If the firm's market capitalization rate is 10%, what is the present value of its growth opportunities?      |  |  | | --- | --- | | **A.** | $25 |  |  |  | | --- | --- | | B. | $50 |  |  |  | | --- | --- | | C. | $75 |  |  |  | | --- | --- | | D. | $100 |   Value with no growth = $5/.10 = $50 Growth rate = .4 × 15% = 6% Value with growth = $5 × (1 - .4)/(.10 - .06) = $75 PVGO = $75 - 50 = $25 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 39. | Annie's Donut Shops, Inc., has expected earnings of $3 per share for next year. The firm's ROE is 18%, and its earnings retention ratio is 60%. If the firm's market capitalization rate is 12%, what is the value of the firm excluding any growth opportunities?      |  |  | | --- | --- | | **A.** | $25 |  |  |  | | --- | --- | | B. | $50 |  |  |  | | --- | --- | | C. | $83.33 |  |  |  | | --- | --- | | D. | $208 |   Value with no growth = $3/.12 = $25 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 40. | Flanders, Inc., has expected earnings of $4 per share for next year. The firm's ROE is 8%, and its earnings retention ratio is 40%. If the firm's market capitalization rate is 15%, what is the present value of its growth opportunities?      |  |  | | --- | --- | | **A.** | -$6.33 |  |  |  | | --- | --- | | B. | $0 |  |  |  | | --- | --- | | C. | $20.34 |  |  |  | | --- | --- | | D. | $26.67 |   Value with no growth = $4/.15 = $26.67 Growth rate = .4 × 8% = 3.2% Value with growth = $4 × (1 - .4)/(.15 - .032) = $20.34 PVGO = $20.34 - 26.67 = -$6.33 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 41. | Firm A is high-risk, and Firm B is low-risk. Everything else equal, which firm would you expect to have a higher P/E ratio?      |  |  | | --- | --- | | A. | Firm A |  |  |  | | --- | --- | | B. | Firm B |  |  |  | | --- | --- | | **C.** | Both would have the same P/E if they were in the same industry. |  |  |  | | --- | --- | | D. | There is not necessarily any linkage between risk and P/E ratios. | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 42. | Firms with higher expected growth rates tend to have P/E ratios that are \_\_\_\_\_\_\_\_\_\_\_ the P/E ratios of firms with lower expected growth rates.      |  |  | | --- | --- | | **A.** | higher than |  |  |  | | --- | --- | | B. | equal to |  |  |  | | --- | --- | | C. | lower than |  |  |  | | --- | --- | | D. | There is not necessarily any linkage between risk and P/E ratios. | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 43. | Value stocks are more likely to have a PEG ratio \_\_\_\_\_.      |  |  | | --- | --- | | **A.** | less than 1 |  |  |  | | --- | --- | | B. | equal to 1 |  |  |  | | --- | --- | | C. | greater than 1 |  |  |  | | --- | --- | | D. | less than zero | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 44. | Generally speaking, as a firm progresses through the industry life cycle, you would expect the PVGO to \_\_\_\_\_\_\_\_ as a percentage of share price.      |  |  | | --- | --- | | A. | increase |  |  |  | | --- | --- | | **B.** | decrease |  |  |  | | --- | --- | | C. | stay the same |  |  |  | | --- | --- | | D. | No typical pattern can be expected. | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Multistage Growth Models* |

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| 45. | Cache Creek Manufacturing Company is expected to pay a dividend of $4.20 in the upcoming year. Dividends are expected to grow at the rate of 8% per year. The risk-free rate of return is 4%, and the expected return on the market portfolio is 14%. Investors use the CAPM to compute the market capitalization rate on the stock and use the constant-growth DDM to determine the intrinsic value of the stock. The stock is trading in the market today at $84. Using the constant-growth DDM and the CAPM, the beta of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 1.4 |  |  |  | | --- | --- | | **B.** | .9 |  |  |  | | --- | --- | | C. | .8 |  |  |  | | --- | --- | | D. | .5 |   *k* = $4.20/$84 + .08 = .13 .13 = .04 + β(.14 - .04) β = .09/.10 = .9 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 46. | Westsyde Tool Company is expected to pay a dividend of $1.50 in the upcoming year. The risk-free rate of return is 6%, and the expected return on the market portfolio is 14%. Analysts expect the price of Westsyde Tool Company shares to be $29 a year from now. The beta of Westsyde Tool Company's stock is 1.2. Using the CAPM, an appropriate required return on Westsyde Tool Company's stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 8% |  |  |  | | --- | --- | | B. | 10.8% |  |  |  | | --- | --- | | **C.** | 15.6% |  |  |  | | --- | --- | | D. | 16.8% |   *k* = .06 + 1.20(.14 - .06) = .156 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 47. | Westsyde Tool Company is expected to pay a dividend of $2 in the upcoming year. The risk-free rate of return is 6%, and the expected return on the market portfolio is 12%. Analysts expect the price of Westsyde Tool Company shares to be $29 a year from now. The beta of Westsyde Tool Company's stock is 1.2. Using a one-period valuation model, the intrinsic value of Westsyde Tool Company stock today is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $24.29 |  |  |  | | --- | --- | | **B.** | $27.39 |  |  |  | | --- | --- | | C. | $31.13 |  |  |  | | --- | --- | | D. | $34.52 |   *k* = .06 + 1.2(.12 - .06) = .132 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 48. | Todd Mountain Development Corporation is expected to pay a dividend of $2.50 in the upcoming year. Dividends are expected to grow at the rate of 8% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 12%. The stock of Todd Mountain Development Corporation has a beta of .75. Using the CAPM, the return you should require on the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 7.25% |  |  |  | | --- | --- | | **B.** | 10.25% |  |  |  | | --- | --- | | C. | 14.75% |  |  |  | | --- | --- | | D. | 21% | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 49. | Todd Mountain Development Corporation is expected to pay a dividend of $3 in the upcoming year. Dividends are expected to grow at the rate of 8% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 17%. The stock of Todd Mountain Development Corporation has a beta of .75. Using the constant-growth DDM, the intrinsic value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 4 |  |  |  | | --- | --- | | B. | 17.65 |  |  |  | | --- | --- | | C. | 37.50 |  |  |  | | --- | --- | | **D.** | 50 |   *k* = .05 + .75(.17 - .05) = .14 *V*0 = [3/(.14 - .08)] = 50 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 50. | Generally speaking, the higher a firm's ROA, the \_\_\_\_\_\_\_\_\_ the dividend payout ratio and the \_\_\_\_\_\_\_\_\_ the firm's growth rate of earnings.      |  |  | | --- | --- | | A. | higher; lower |  |  |  | | --- | --- | | B. | higher; higher |  |  |  | | --- | --- | | C. | lower; lower |  |  |  | | --- | --- | | **D.** | lower; higher | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 51. | Interior Airline is expected to pay a dividend of $3 in the upcoming year. Dividends are expected to grow at the rate of 10% per year. The risk-free rate of return is 4%, and the expected return on the market portfolio is 13%. The stock of Interior Airline has a beta of 4. Using the constant-growth DDM, the intrinsic value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | $10 |  |  |  | | --- | --- | | B. | $22.73 |  |  |  | | --- | --- | | C. | $27.78 |  |  |  | | --- | --- | | D. | $41.67 |   *k* = .04 + .4(.13 - .04) = .4 *V*0 = [3/(.4 - .1)] = 10 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 52. | Caribou Gold Mining Corporation is expected to pay a dividend of $4 in the upcoming year. Dividends are expected to decline at the rate of 3% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 13%. The stock of Caribou Gold Mining Corporation has a beta of .5. Using the CAPM, the return you should require on the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | 2% |  |  |  | | --- | --- | | B. | 5% |  |  |  | | --- | --- | | C. | 8% |  |  |  | | --- | --- | | **D.** | 9% |   *k* = .05 + .5(.13 - .05) = .09 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 53. | Caribou Gold Mining Corporation is expected to pay a dividend of $6 in the upcoming year. Dividends are expected to decline at the rate of 3% per year. The risk-free rate of return is 5%, and the expected return on the market portfolio is 13%. The stock of Caribou Gold Mining Corporation has a beta of .5. Using the constant-growth DDM, the intrinsic value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | $50 |  |  |  | | --- | --- | | B. | $100 |  |  |  | | --- | --- | | C. | $150 |  |  |  | | --- | --- | | D. | $200 |   *k* = .05 + .5(.13 - .05) = .09 *V*0 = {6/[.09 - (-.03)]} = 50 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 54. | Lifecycle Motorcycle Company is expected to pay a dividend in year 1 of $2, a dividend in year 2 of $3, and a dividend in year 3 of $4. After year 3, dividends are expected to grow at the rate of 7% per year. An appropriate required return for the stock is 12%. Using the multistage DDM, the stock should be worth \_\_\_\_\_\_\_\_\_\_ today.      |  |  | | --- | --- | | A. | $63.80 |  |  |  | | --- | --- | | B. | $65.13 |  |  |  | | --- | --- | | **C.** | $67.95 |  |  |  | | --- | --- | | D. | $85.60 |   *V*3 = $4 × (1.07)/(.12 - .07) = $85.60 is the value of *D*4, *D*5, . . . ∞ The total value at time 3 is $4 + 85.60 = $89.60 The discounted cash flows are |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Multistage Growth Models* |

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| 55. | Ace Frisbee Corporation produces a good that is very mature in the firm's product life cycles. Ace Frisbee Corporation is expected to pay a dividend in year 1 of $3, a dividend in year 2 of $2, and a dividend in year 3 of $1. After year 3, dividends are expected to decline at the rate of 2% per year. An appropriate required return for the stock is 8%. Using the multistage DDM, the stock should be worth \_\_\_\_\_\_\_\_\_\_ today.      |  |  | | --- | --- | | **A.** | $13.07 |  |  |  | | --- | --- | | B. | $13.58 |  |  |  | | --- | --- | | C. | $18.25 |  |  |  | | --- | --- | | D. | $18.78 |   *V*3 = $1× (0.98)/[.08 - (-.02)] = $9.80 is the value of *D*4, *D*5, . . . ∞ The total value at time 3 is $1 + 9.80 = $10.80 The discounted cash flows are |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Multistage Growth Models* |

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| 56. | A firm's earnings per share increased from $10 to $12, its dividends increased from $4 to $4.40, and its share price increased from $80 to $100. Given this information, it follows that \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | the stock experienced a drop in its P/E ratio |  |  |  | | --- | --- | | **B.** | the company had a decrease in its dividend payout ratio |  |  |  | | --- | --- | | C. | both earnings and share price increased by 20% |  |  |  | | --- | --- | | D. | the required rate of return increased | |

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| *AACSB: Reflective Thinking Blooms: Understand Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 57. | Assuming all other factors remain unchanged, \_\_\_\_\_\_\_\_\_\_ would increase a firm's price-earnings ratio.      |  |  | | --- | --- | | A. | an increase in the dividend payout ratio |  |  |  | | --- | --- | | **B.** | a reduction in investor risk aversion |  |  |  | | --- | --- | | C. | an expected increase in the level of inflation |  |  |  | | --- | --- | | D. | an increase in the yield on Treasury bills | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 58. | A company with an expected earnings growth rate which is greater than that of the typical company in the same industry most likely has \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | a dividend yield which is greater than that of the typical company |  |  |  | | --- | --- | | **B.** | a dividend yield which is less than that of the typical company |  |  |  | | --- | --- | | C. | less risk than the typical company |  |  |  | | --- | --- | | D. | less sensitivity to market trends than the typical company | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Stock Prices and Investment Opportunities* |

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| 59. | Everything else equal, which variable is negatively related to the intrinsic value of a company?      |  |  | | --- | --- | | A. | *D*1 |  |  |  | | --- | --- | | B. | *D*0 |  |  |  | | --- | --- | | C. | *g* |  |  |  | | --- | --- | | **D.** | *k* | |

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| *AACSB: Reflective Thinking Blooms: Understand Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 60. | Sanders, Inc., paid a $4 dividend per share last year and is expected to continue to pay out 60% of its earnings as dividends for the foreseeable future. If the firm is expected to generate a 13% return on equity in the future, and if you require a 15% return on the stock, the value of the stock is \_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | $26.67 |  |  |  | | --- | --- | | B. | $35.19 |  |  |  | | --- | --- | | **C.** | $42.94 |  |  |  | | --- | --- | | D. | $59.89 |   *g* = (1 - .6) × 13% = 5.2% *D*1 = $4 × (1.052) = $4.208 Intrinsic value = $4.208/(.15 - .052) = $42.94 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 61. | A firm has PVGO of 0 and a market capitalization rate of 12%. What is the firm's P/E ratio?      |  |  | | --- | --- | | A. | 12 |  |  |  | | --- | --- | | **B.** | 8.33 |  |  |  | | --- | --- | | C. | 10.25 |  |  |  | | --- | --- | | D. | 18.55 |   *P* = *E*/*k* + 0; P/E = 1/.12 = 8.33 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 62. | A firm has an earnings retention ratio of 40%. The stock has a market capitalization rate of 15% and an ROE of 18%. What is the stock's P/E ratio?      |  |  | | --- | --- | | A. | 12.82 |  |  |  | | --- | --- | | **B.** | 7.69 |  |  |  | | --- | --- | | C. | 8.33 |  |  |  | | --- | --- | | D. | 9.46 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 63. | A common stock pays an annual dividend per share of $1.80. The risk-free rate is 5%, and the risk premium for this stock is 4%. If the annual dividend is expected to remain at $1.80 per share, what is the value of the stock?      |  |  | | --- | --- | | A. | $17.78 |  |  |  | | --- | --- | | **B.** | $20 |  |  |  | | --- | --- | | C. | $40 |  |  |  | | --- | --- | | D. | None of these options |   *P* = $1.80/.09 = $20 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 64. | Transportation stocks currently provide an expected rate of return of 15%. TTT, a large transportation company, will pay a year-end dividend of $3 per share. If the stock is selling at $60 per share, what must be the market's expectation of the constant-growth rate of TTT dividends?      |  |  | | --- | --- | | A. | 5% |  |  |  | | --- | --- | | **B.** | 10% |  |  |  | | --- | --- | | C. | 20% |  |  |  | | --- | --- | | D. | None of these options |   *k* = *D*1/*P*0 + *g* .15 = 3/60 + *g* *g* = .10 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 65. | A stock is priced at $45 per share. The stock has earnings per share of $3 and a market capitalization rate of 14%. What is the stock's PVGO?      |  |  | | --- | --- | | **A.** | $23.57 |  |  |  | | --- | --- | | B. | $15 |  |  |  | | --- | --- | | C. | $19.78 |  |  |  | | --- | --- | | D. | $21.34 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 66. | A firm increases its dividend plowback ratio. All else equal, you know that \_\_\_\_\_\_\_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | earnings growth will increase and the stock's P/E will increase |  |  |  | | --- | --- | | B. | earnings growth will decrease and the stock's P/E will increase |  |  |  | | --- | --- | | C. | earnings growth will increase and the stock's P/E will decrease |  |  |  | | --- | --- | | **D.** | earnings growth will increase and the stock's P/E may or may not increase | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 67. | A firm has a stock price of $54.75 per share. The firm's earnings are $75 million, and the firm has 20 million shares outstanding. The firm has an ROE of 15% and a plowback of 65%. What is the firm's PEG ratio?      |  |  | | --- | --- | | **A.** | 1.5 |  |  |  | | --- | --- | | B. | 1.25 |  |  |  | | --- | --- | | C. | 1.1 |  |  |  | | --- | --- | | D. | 1 |   EPS = $75,000,000/20,000,000 = $3.75 P/E = $54.75/$3.75 = 14.6 *g* = .65 × 15% = .0975 = 9.75% PEG = 14.6/9.75 = 1.5 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 68. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  At what price would you expect ART to sell?      |  |  | | --- | --- | | A. | $25 |  |  |  | | --- | --- | | **B.** | $34.29 |  |  |  | | --- | --- | | C. | $42.86 |  |  |  | | --- | --- | | D. | $45.67 | |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 69. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  At what P/E ratio would you expect ART to sell?      |  |  | | --- | --- | | A. | 8.33 |  |  |  | | --- | --- | | **B.** | 11.43 |  |  |  | | --- | --- | | C. | 14.29 |  |  |  | | --- | --- | | D. | 15.25 |   P/E = 34.29/3 = 11.43 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 70. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  What is the present value of growth opportunities for ART?      |  |  | | --- | --- | | A. | $8.57 |  |  |  | | --- | --- | | **B.** | $9.29 |  |  |  | | --- | --- | | C. | $14.29 |  |  |  | | --- | --- | | D. | $16.29 |   PVGO = *P*0 - (EPS1/*k*) = 34.29 - (3/.12) = $9.29 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 71. | ART has come out with a new and improved product. As a result, the firm projects an ROE of 25%, and it will maintain a plowback ratio of .20. Its earnings this year will be $3 per share. Investors expect a 12% rate of return on the stock.  What price do you expect ART shares to sell for in 4 years?      |  |  | | --- | --- | | A. | $53.96 |  |  |  | | --- | --- | | B. | $44.95 |  |  |  | | --- | --- | | **C.** | $41.68 |  |  |  | | --- | --- | | D. | $39.76 |   *P*3 = *P*0 (1 + *g*)4 = 34.29(1.05)4 = 41.68 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 72. | The EBIT of a firm is $300, the tax rate is 35%, the depreciation is $20, capital expenditures are $60, and the increase in net working capital is $30. What is the free cash flow to the firm?      |  |  | | --- | --- | | A. | $85 |  |  |  | | --- | --- | | **B.** | $125 |  |  |  | | --- | --- | | C. | $185 |  |  |  | | --- | --- | | D. | $305 |   FCFF = 300(1 - .35) + 20 - 60 - 30 = $125 million |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 73. | A firm reports EBIT of $100 million. The income statement shows depreciation of $20 million. If the tax rate is 35% and total capital expenditures and increases in working capital total $10 million, what is the free cash flow to the firm?      |  |  | | --- | --- | | A. | $57 |  |  |  | | --- | --- | | B. | $65 |  |  |  | | --- | --- | | **C.** | $75 |  |  |  | | --- | --- | | D. | $95 |   FCFF = 100(1 - .35) + 20 - 10 = $75 million |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 74. | The free cash flow to the firm is $300 million in perpetuity, the cost of equity equals 14%, and the WACC is 10%. If the market value of the debt is $1 billion, what is the value of the equity using the free cash flow valuation approach?      |  |  | | --- | --- | | A. | $1 billion |  |  |  | | --- | --- | | **B.** | $2 billion |  |  |  | | --- | --- | | C. | $3 billion |  |  |  | | --- | --- | | D. | $4 billion |   Total value = 300/.10 = $3 billion Equity value = $3 billion - 1 billion = $2 billion |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 75. | If a firm has a free cash flow equal to $50 million and that cash flow is expected to grow at 3% forever, what is the total firm value given a WACC of 9.5%?      |  |  | | --- | --- | | A. | $679.81 million |  |  |  | | --- | --- | | B. | $715.54 million |  |  |  | | --- | --- | | **C.** | $769.23 million |  |  |  | | --- | --- | | D. | $803.03 million |   Total value = 50/(.095 - .03) = 769.23 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 76. | The free cash flow to the firm is reported as $405 million. The interest expense to the firm is $76 million. If the tax rate is 35% and the net debt of the firm increased by $50 million, what is the free cash flow to the equity holders of the firm?      |  |  | | --- | --- | | **A.** | $405.6 million |  |  |  | | --- | --- | | B. | $454.2 million |  |  |  | | --- | --- | | C. | $505.8 million |  |  |  | | --- | --- | | D. | $553.5 million |   FCFE = 405 - 76(1 - .35) + 50 = 405.6 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 77. | The free cash flow to the firm is reported as $275 million. The interest expense to the firm is $60 million. If the tax rate is 35% and the net debt of the firm increased by $33 million, what is the free cash flow to the equity holders of the firm?      |  |  | | --- | --- | | **A.** | $269 million |  |  |  | | --- | --- | | B. | $296 million |  |  |  | | --- | --- | | C. | $305 million |  |  |  | | --- | --- | | D. | $327 million |   FCFE = 275 - 60(1 - .35) + 33 = 269 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 78. | The free cash flow to the firm is reported as $205 million. The interest expense to the firm is $22 million. If the tax rate is 35% and the net debt of the firm increased by $25 million, what is the approximate market value of the firm if the FCFE grows at 2% and the cost of equity is 11%?      |  |  | | --- | --- | | A. | $2,168 billion |  |  |  | | --- | --- | | **B.** | $2,445 billion |  |  |  | | --- | --- | | C. | $2,565 billion |  |  |  | | --- | --- | | D. | $2,998 billion |   FCFE = 205 - 22(1 - .35) + 25 = 215.70 Value = (215.7×1.02)/(.11 - .02) = 2,445 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 79. | The free cash flow to the firm is reported as $198 million. The interest expense to the firm is $15 million. If the tax rate is 35% and the net debt of the firm increased by $20 million, what is the approximate market value of the firm if the FCFE grows at 3% and the cost of equity is 14%?      |  |  | | --- | --- | | **A.** | $1,950 billion |  |  |  | | --- | --- | | B. | $2,497 billion |  |  |  | | --- | --- | | C. | $2,585 billion |  |  |  | | --- | --- | | D. | $3,098 billion |   FCFE = 198 - 15(1 - .35) + 20 = 208.25 Value = (208.25 × 1.03)/(.14 - .03) = 1,950 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 80. | Firm A has a stock price of $35, and 60% of the value of the stock is in the form of PVGO. Firm B also has a stock price of $35, but only 20% of the value of stock B is in the form of PVGO. We know that:  I. Stock A will give us a higher return than Stock B. II. An investment in stock A is probably riskier than an investment in stock B. III. Stock A has higher forecast earnings growth than stock B.      |  |  | | --- | --- | | A. | I only |  |  |  | | --- | --- | | B. | I and II only |  |  |  | | --- | --- | | **C.** | II and III only |  |  |  | | --- | --- | | D. | I, II, and III | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 81. | A firm is expected to produce earnings next year of $3 per share. It plans to reinvest 25% of its earnings at 20%. If the cost of equity is 11%, what should be the value of the stock?      |  |  | | --- | --- | | A. | $27.27 |  |  |  | | --- | --- | | **B.** | $37.50 |  |  |  | | --- | --- | | C. | $66.67 |  |  |  | | --- | --- | | D. | $70 |   *g* = .25 × .20 = .05 *D*1 = $3(1 - .25) = $2.25 *P*0 = $2.25/(.11 - .05) = $37.50 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 82. | Next year's earnings are estimated to be $5. The company plans to reinvest 20% of its earnings at 15%. If the cost of equity is 9%, what is the present value of growth opportunities?      |  |  | | --- | --- | | A. | $9.09 |  |  |  | | --- | --- | | B. | $10.10 |  |  |  | | --- | --- | | **C.** | $11.11 |  |  |  | | --- | --- | | D. | $12.21 |   *g* = .20 × .15 = .03 Value with growth = ($5 × .80)/(.09 - .03) = 66.67 Value without growth = $5/.09 = $55.56 PVGO = $66.67 - 55.56 = $11.11 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 83. | Next year's earnings are estimated to be $6. The company plans to reinvest 33% of its earnings at 12%. If the cost of equity is 8%, what is the present value of growth opportunities?      |  |  | | --- | --- | | A. | $6 |  |  |  | | --- | --- | | **B.** | $24.50 |  |  |  | | --- | --- | | C. | $44.44 |  |  |  | | --- | --- | | D. | $75 |   *g* = .33 × .12 = .0396 Value with growth = ($6 × .67)/(.08 - .0396) = $99.50 Value without growth = $6/.08 = $75 PVGO = $99.50 - 75 = $24.50 |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 84. | When Google's share price reached $475 per share, Google had a P/E ratio of about 68 and an estimated market capitalization rate of 11.5%. Google pays no dividends. Approximately what percentage of Google's stock price was represented by PVGO?      |  |  | | --- | --- | | A. | 92% |  |  |  | | --- | --- | | **B.** | 87% |  |  |  | | --- | --- | | C. | 77% |  |  |  | | --- | --- | | D. | 64% |   EPS = $475/68 = $6.985 PVGO = $475 - ($6.985/.115) = $414.26 $414.26/$475 = 87.21% |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 85. | A firm has a stock price of $55 per share and a P/E ratio of 75. If you buy the stock at this P/E and earnings fail to grow at all, how long should you expect it to take to just recover the cost of your investment?      |  |  | | --- | --- | | A. | 27 years |  |  |  | | --- | --- | | B. | 37 years |  |  |  | | --- | --- | | C. | 55 years |  |  |  | | --- | --- | | **D.** | 75 years |   EPS = $55/75 = $.73333 per year Payback period = $55/$.73333 per year = 75 years |

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| *AACSB: Analytic Blooms: Apply Difficulty: 2 Medium Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: The Price-Earnings Ratio and Growth Opportunities* |

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| 86. | In what industry are investors likely to use the dividend discount model and arrive at a price close to the observed market price?      |  |  | | --- | --- | | A. | Import/export trade |  |  |  | | --- | --- | | B. | Software |  |  |  | | --- | --- | | C. | Telecommunications |  |  |  | | --- | --- | | **D.** | Utility | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Dividend Discount Models* |

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| 87. | Estimates of a stock's intrinsic value calculated with the free cash flow methodology depend most critically on \_\_\_\_\_\_\_.      |  |  | | --- | --- | | **A.** | the terminal value used |  |  |  | | --- | --- | | B. | whether one uses FCFF or FCFE |  |  |  | | --- | --- | | C. | the time period used to estimate the cash flows |  |  |  | | --- | --- | | D. | whether the firm is currently paying dividends | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-04 Value a firm using free cash flow models. Topic: Free Cash Flow Valuation Approaches* |

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| 88. | The greatest value to an analyst from calculating a stock's intrinsic value is \_\_\_\_\_\_\_.      |  |  | | --- | --- | | A. | how easy it is to come up with accurate model inputs |  |  |  | | --- | --- | | B. | the precision of the value estimate |  |  |  | | --- | --- | | **C.** | how the process forces analysts to understand the critical variables that have the greatest impact on value |  |  |  | | --- | --- | | D. | how all the different models typically yield identical value results | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-02 Calculate the intrinsic value of a firm using either a constant-growth or multistage dividend discount model. Topic: Intrinsic Value versus Market Price* |

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| 89. | Which of the following valuation measures is often used to compare firms that have no earnings?      |  |  | | --- | --- | | A. | Price-to-book ratio |  |  |  | | --- | --- | | B. | P/E ratio |  |  |  | | --- | --- | | C. | Price-to-cash-flow ratio |  |  |  | | --- | --- | | **D.** | Price-to-sales ratio | |

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| *AACSB: Analytic Blooms: Remember Difficulty: 1 Easy Learning Objective: 13-03 Assess the growth prospects of a firm; and relate growth opportunities to the P/E ratio. Topic: Other Comparative Valuation Ratios* |