FNCE 20005 Corporate Financial Decision Making 2021

TUTORIAL 10: Corporate Takeovers & Restructuring - Part 4 & Real Options
Answers to Section B questions to be submitted on Canvas by 10am on Monday, October 18th

SECTION A

Question 1

Briefly outline each of these methods of corporate restructuring:

Divestitures; Spin-offs; Equity carve-outs; LBO

Question 2

Explain how the notion of real options may explain why we observe that exporters are slow to cease supplying overseas markets following adverse changes in exchange rates.

SECTION B – PRIORITY QUESTIONS

Question 3

"Leveraged buyouts follow a simple model - the PE firm acquires a listed firm, delists it, loads it up with debt and sell it off to the market. Given that the equity contribution is so low - there is virtually no risk to the private equity firm." Comment upon this statement.

Question 4

This uses the decision-tree from before – you can use your earlier work to answer this week's question

It is the end of your final year of study as a student in the Master of Finance program and you are trying to determine what you are going to do over the remaining 35 years of your working life. You are trying to decide whether you should remain at university and do your PhD in finance or alternatively leave university and become a consultant.

You anticipate that it will take you 5 years to complete your PhD during which time you will earn a real net cash flow of $25,000 p.a. At the end of these 5 years you must decide whether to remain at the university as an academic or take up a career as a consultant. There is a 10% chance that you will enjoy great success as an academic earning a salary of $85,000 p.a., a 50% chance that you will have a moderately successful career earning a salary of $65,000 p.a. and a 40% chance that you will have an unsuccessful academic career earning a salary of only $45,000 p.a. If you decide to become a consultant then it will initially cost you $100,000 to set up your business and there is an 80% chance of generating $60,000 p.a. and a 20% chance of generating $120,000 p.a..

If you decide not do a PhD and instead become a consultant immediately, there is a 60% chance that you will earn $70,000 p.a. and a 40% chance that you will earn $50,000 p.a. over the remainder of your working life.

Assume that all cash flows (other than those specified otherwise) occur at year-end, are expressed in real terms (that is in terms of purchasing power today) and that the real opportunity cost of capital is 10%.

[This is the new bit below!]

You are to assume that for personal (as opposed to financial) reasons, you have decided to do a PhD. Using the decision tree approach, estimate the value of the option associated with not having to stay in academia after you acquire your PhD.