

Chapter 5: Capital structure and dividends

Answers to self test questions

1. Correct answers are:

- | | | |
|-----|---------------------------------------|-------|
| (a) | No specified maturity | True |
| (b) | No predetermined returns | True |
| (c) | No property rights attached to them | False |
| (d) | A priority claim on the firm's income | False |

2. Correct answers are:

- | | | |
|-----|---------------------------------------|-------|
| (a) | No specified maturity | False |
| (b) | No predetermined returns | False |
| (c) | No property rights attached to them | True |
| (d) | A priority claim on the firm's income | True |

3. Correct answers are:

- | | | |
|-----|-------------------|-------|
| (a) | Forward contracts | True |
| (b) | Future contracts | True |
| (c) | Options | True |
| (d) | Spot contracts | False |

4. Correct answers are:

- | | | |
|-----|--|-------|
| (a) | By collateral such as mortgages | True |
| (b) | By converting them into traded securities | False |
| (c) | By clauses in the debt contract, such as ratio clauses | True |

5. Correct answers are:

- | | | |
|-----|--|-------|
| (a) | By collateral such as mortgages | False |
| (b) | By converting them into traded securities | True |
| (c) | By clauses in the debt contract, such as ratio clauses | False |

6. Correct answers are:

- | | | |
|-----|-----------------------------------|-------|
| (a) | Common shares | True |
| (b) | Dual class shares (A or B shares) | True |
| (c) | Golden shares | False |
| (d) | Non-voting shares | True |
| (e) | Preferred shares | True |

7. (c) Zero coupon bonds

8. (b) Junk bonds

9. (e) Convertible bonds

10. Correct answers are:

- | | | |
|-----|---|-------|
| (a) | Arranging finance for large engineering projects | False |
| (b) | Constructing new securities from existing securities | True |
| (c) | Making securities accessible to, or customized for, groups of investors | True |
| (d) | Re-distributing risk and return | True |

11. (b) The combination of capital categories it uses to finance its operations

12. Correct answers are:

- | | | |
|-----|--|-------|
| (a) | There are no taxes or transaction costs | True |
| (b) | All assets are marketable and perfectly divisible | True |
| (c) | There are no limitations on short selling | True |
| (d) | Investors have perfect foresight | False |
| (e) | There are no limitations on risk free borrowing or lending | True |
| (f) | Firms cannot create unique investment opportunities by changing their capital structures | False |
| (g) | There are large numbers of buyers and sellers, none of which can individually influence prices | True |
| (h) | All information is simultaneously and costlessly available to all investors | True |

Perfect markets are not necessarily complete (answer (f))

13. (c) Modigliani-Miller proposition 2 without taxes and without default risk/limited liability

14. (a) Modigliani-Miller proposition 2 with taxes and without default risk/limited liability

15. (b) The return on equity increases with leverage

16. (b) Modigliani-Miller proposition 2 with default risk/limited liability and without taxes

17. (a) The required return on the company's equity decreases

18. (a) The company's WACC decreases

19. (a) The value of the firm increases with leverage

20. (c) Because larger debt obligations mean a larger probability that the firm's cash flow is insufficient to meet them

21. (d) The marginal expected tax advantage equals the marginal expected costs of financial distress

22. Correct answers are:

- | | | |
|-----|--|-------|
| (a) | The proportion of growth opportunities in total firm value | False |
| (b) | The volatility of the firm's earnings | False |
| (c) | The tax rate | True |
| (d) | The firm's profitability | True |
| (e) | Firm size | True |

23. Correct answers are:

- | | | |
|-----|--|-------|
| (a) | The proportion of growth opportunities in total firm value | True |
| (b) | The volatility of the firm's earnings | True |
| (c) | The tax rate | False |
| (d) | The firm's profitability | True |
| (e) | Firm size | False |

24. (c) When equity is overpriced (bad news is coming up)
25. (c) By issuing shares
26. Correct answers are:
- | | |
|--|-------|
| (a) Taxes and transaction costs | True |
| (b) Assets are not perfectly divisible | False |
| (c) Limitations on short selling | False |
| (d) Information asymmetry | True |
27. (b) Arbitrage in perfect markets
28. (b) Stock repurchases do not lower the stock price