FIN 521: Problem Set #4

Due on Sunday, May 6, 2018

Wanbae Park

Question 1

a. Let x denote the current price per share. Then market capitalization of the firm is equal to $x\times$ 8 million dollars before the investment. After investment, market capitalization of the firm will be $8x + 1$ million dollars, and the portion of venture capitalist will be $\frac{1}{8x+1}$, which will be equal to 0.2. Therefore, by solving the equation, current price of share is equal to 0.5 dollars, and the venture capitalist will get 2 million shares.

b. Since there are 10 million shares after investment and price per share is \$0.5, the value of firm is equal to $0.5 \times 2 = 1$ million dollars.

Question 2

a. Since the IPO price was \$20 per share and there is 7% underwriting spread, the amount of capital raise is equal to $(1 - 0.07) \times 20 \times 5 = 93$ million dollars.

b. After IPO, since 5 million shares are added, there are 15 million shares of the firm. Because the share price increased to \$50, market value of equity of the firm is equal to $50 \times 15 = 750$ million dollars.

c. Since market is perfect, the current share price of firm must be equal to \$50. Therefore, because there is 10 million shares before issuing stock, pre-money value of the equity is equal to $50 \times 10 = 500$ million dollars. Under perfect market, because the firm will issue stock at the fair price: \$50, if the firm issues 5 million shares, the amount of capital risen is equal to $50 \times 5 = 250$ million dollars. Therefore, post-money value of equity is equal to 750 million dollars. Under this circumstances, in order to raise 93 million dollars as in question a, it needs to issue $93/50 = 1.86$ million shares, which is quite less than the amount of issuance at question a.

d. Due to underpricing and underwriting spread, the firm can only raise 93 million dollars for issuing 5 million shares, comparing 250 million dollars when market is perfect. Therefore, it can be concluded that $250 - 93 = 157$ million dollars are left on the table due to market imperfection.

Question 3

a. Since the amount of money risen only depends on primary shares. Therefore, because the amount of primary share is equal to 5 million, considering the underwriter charges, the amount of money risen is equal to $5 \times 42.50 \times (1 - 0.05) = 201.875$ million dollars.

b. Since the venture capitalist sold 3 million shares, they received $3 \times 42.50 \times (1 - 0.05) = 121.125$ million dollars.

Question 4

a. From the question, the total earning of my company and TargetCo is 4 million and 2 million dollars respectively. Since the market value of equity of TargetCo is 2.5 million dollars, in order to buy TargetCo, my company has to issue $25,000,000/40 = 625,000$ shares, if there is no premium. Therefore, since the number of shares increases to 1,625,000 and total earning becomes 6 million dollars, EPS will be $6,000,000/1,625,000 = \$3.69$.

b. Since there is 20% premium to buy TargetCo, shareholders of TargetCo will get $\frac{25{,}000{,}000}{40} \times 1.2 = 750,000$ shares of my company. Since the total earning of mergered firm is 6 million dollars, EPS will be equal to $6,000,000/1,750,000 = \$3.43$.

c. Earning per share in (b) is less than (a) because there is a premium in merger, and the amount of premium is financed by issuing stock. Since there is no synergy, the original shareholders of my firm will be worse off because they paid premium. In contrast, shareholders of TargetCo will be better of because they get premium.

d. Before the merger, P/E ratio of my company is $40/4 = 10$. However, after the merger, because there is no synergy, P/E ratio will be increased to $40/3.69 = 10.33$. TargetCo's P/E ratio before the merger is $25/2 = 12.5$. By merging firm which has higher EPS, a company can raise its P/E ratio although there is no fundamental effect.

Question 5

The maximum exchange ratio is attained when NPV of merger is zero. This condition pins down to the following equation.

$$Exchange\ Ratio = \frac{P_T}{P_A}\left(1 + \frac{S}{T}\right)$$

where P_T and P_A is share price of target firm and the original firm, respectively. S and T denote the value of synergy and target firm. Therefore, plugging the given value to the equation above, we can find that the maximum exchange ratio as $\frac{25}{35}(1 + \frac{1}{4}) = 0.893$.

Question 6

a. In this case, since there are cash flows only at 2 dates (investment date and end of 10 years), the IRR can be calculated by solving the following equation.

$$80 = \frac{400}{(1 + IRR)^{10}}$$

By solving the equation above, the IRR is calculated as 17.46%.

Question 6 continued on next page...

b. In this case, there are 4 sources of cash flow. First, the amount of initial investment is 100 million dollars. Second, the limited partner should pay 2 million dollars at each year for management fee. Third, the investment will be worth 400 million dollars. Fourth, because the net profit of the fund is $400 - 100 - 2 \times 10 = 280$, the limited partner shoula pay $280 \times 0.2 = 56$ million dollars for interest. Considering the cash flows, IRR is calculated as 11.94%.

Question 7

There are lots of ways to motivate managers to act for owner's interest. First, paying for their performance can be a way like granting executive stock options. Second, monitoring by board of directors and other monitors can reduce agency costs. Third, shareholders may try to replace directors in board election. Fourth, by executing hostile takeover, it is possible to reduce agency cost.

Question 8

Since the CEO has 3% of the firm, if the acquisition is executed, CEO will lose $0.03 \times 50 = 1.5$ million dollars. However, since present value of compensation is 5 million dollars. By acquiring, CEO can get 3.5 million dollars, which is profit to CEO. However, since the acquisition destroys 50 million of GreenFrame's value, shareholders will be worse off unless present value of synergy is larger than 50 million dollars.