

GESTÃO FINANCEIRA II

PROBLEM SET 2

(FROM BERK AND DEMARZO'S "CORPORATE FINANCE")

LICENCIATURA – UNDERGRADUATE COURSE

1ST SEMESTER 2010-2011



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Chapter 8

Valuing Bonds

8-3. The following table summarizes prices of various default-free, zero-coupon bonds (expressed as a percentage of face value):

Maturity (years)	1	2	3	4	5
Price (per \$100 face value)	\$95.51	\$91.05	\$86.38	\$81.65	\$76.51

- Compute the yield to maturity for each bond.
 - Plot the zero-coupon yield curve (for the first five years).
 - Is the yield curve upward sloping, downward sloping, or flat?
- 8-5. In the box in Section 8.1, Bloomberg.com reported that the three-month Treasury bill sold for a price of \$100.002556 per \$100 face value. What is the yield to maturity of this bond, expressed as an EAR?
- 8-14. Suppose you purchase a 30-year, zero-coupon bond with a yield to maturity of 6%. You hold the bond for five years before selling it.
- If the bond's yield to maturity is 6% when you sell it, what is the internal rate of return of your investment?
 - If the bond's yield to maturity is 7% when you sell it, what is the internal rate of return of your investment?
 - If the bond's yield to maturity is 5% when you sell it, what is the internal rate of return of your investment?
 - Even if a bond has no chance of default, is your investment risk free if you plan to sell it before it matures? Explain.
- 8-19. What is the price of a three-year, default-free security with a face value of \$1000 and an annual coupon rate of 4%? What is the yield to maturity for this bond?
- 8-20. What is the maturity of a default-free security with annual coupon payments and a yield to maturity of 4%? Why?
- 8-23. Prices of zero-coupon, default-free securities with face values of \$1000 are summarized in the following table:

Maturity (years)	1	2	3
Price (per \$1000 face value)	\$970.87	\$938.95	\$904.56

- Suppose you observe that a three-year, default-free security with an annual coupon rate of 10% and a face value of \$1000 has a price today of \$1183.50. Is there an arbitrage opportunity? If so, show specifically how you would take advantage of this opportunity. If not, why not?
- 8-24. Assume there are four default-free bonds with the following prices and future cash flows:

Bond	Price Today	Cash Flows		
		Year 1	Year 2	Year 3
A	\$934.58	1000	0	0
B	881.66	0	1000	0
C	1,118.21	100	100	1100
D	839.62	0	0	1000

Do these bonds present an arbitrage opportunity? If so, how would you take advantage of this opportunity? If not, why not?

8-25. Suppose you are given the following information about the default-free, coupon-paying yield curve:

Maturity (years)	1	2	3	4
Coupon rate (annual payments)	0.00%	10.00%	6.00%	12.00%
YTM	2.000%	3.908%	5.840%	5.783%

- Use arbitrage to determine the yield to maturity of a two-year, zero-coupon bond.
 - What is the zero-coupon yield curve for years 1 through 4?
- 8-30. HMK Enterprises would like to raise \$10 million to invest in capital expenditures. The company plans to issue five-year bonds with a face value of \$1000 and a coupon rate of 6.5% (annual payments). The following table summarizes the yield to maturity for five-year (annualpay) coupon corporate bonds of various ratings:



Rating	AAA	AA	A	BBB	BB
YTM	6.20%	6.30%	6.50%	6.90%	7.50%

- Assuming the bonds will be rated AA, what will the price of the bonds be?
- How much total principal amount of these bonds must HMK issue to raise \$10 million today, assuming the bonds are AA rated? (Because HMK cannot issue a fraction of a bond, assume that all fractions are rounded to the nearest whole number.)
- What must the rating of the bonds be for them to sell at par?
- Suppose that when the bonds are issued, the price of each bond is \$959.54. What is the likely rating of the bonds? Are they junk bonds?

Chapter 9

Valuing Stocks

- 9-1. Assume Evco, Inc., has a current price of \$50 and will pay a \$2 dividend in one year, and its equity cost of capital is 15%. What price must you expect it to sell for right after paying the dividend in one year in order to justify its current price?
- 9-2. Anle Corporation has a current price of \$20, is expected to pay a dividend of \$1 in one year, and its expected price right after paying that dividend is \$22.
- What is Anle's expected dividend yield?
 - What is Anle's expected capital gain rate?
 - What is Anle's equity cost of capital?
- 9-6. Summit Systems will pay a dividend of \$1.50 this year. If you expect Summit's dividend to grow by 6% per year, what is its price per share if its equity cost of capital is 11%?
- 9-7. Dorpac Corporation has a dividend yield of 1.5%. Dorpac's equity cost of capital is 8%, and its dividends are expected to grow at a constant rate.
- What is the expected growth rate of Dorpac's dividends?
 - What is the expected growth rate of Dorpac's share price?
- 9-12. Colgate-Palmolive Company has just paid an annual dividend of \$0.96. Analysts are predicting an 11% per year growth rate in earnings over the next five years. After then, Colgate's earnings are expected to grow at the current industry average of 5.2% per year. If Colgate's equity cost of capital is 8.5% per year and its dividend payout ratio remains constant, what price does the dividend-discount model predict Colgate stock should sell for?
- 9-15. Suppose Cisco Systems pays no dividends but spent \$5 billion on share repurchases last year. If Cisco's equity cost of capital is 12%, and if the amount spent on repurchases is expected to grow by 8% per year, estimate Cisco's market capitalization. If Cisco has 6 billion shares outstanding, what stock price does this correspond to?
- 9-17. Benchmark Metrics, Inc. (BMI), an all-equity financed firm, just reported EPS of \$5.00 per share for 2008. Despite the economic downturn, BMI is confident regarding its current investment opportunities. But due to the financial crisis, BMI does not wish to fund these investments externally. The Board has therefore decided to suspend its stock repurchase plan and cut its dividend to \$1 per share (vs. almost \$2 per share in 2007), and retain these funds instead. The firm has just paid the 2008 dividend, and BMI plans to keep its dividend at \$1 per share in 2009 as well. In subsequent years, it expects its growth opportunities to slow, and it will still be able to fund its growth internally with a target 40% dividend payout ratio, and reinitiating its stock repurchase plan for a total payout rate of 60%. (All dividends and repurchases occur at the end of each year.)

Suppose BMI's existing operations will continue to generate the current level of earnings per share in the future. Assume further that the return on new investment is 15%, and that reinvestments will account for all future earnings growth (if any). Finally, assume BMI's equity cost of capital is 10%.

- Estimate BMI's EPS in 2009 and 2010 (before any share repurchases).
- What is the value of a share of BMI at the start of 2009?

9-18. Heavy Metal Corporation is expected to generate the following free cash flows over the next five years:

Year	1	2	3	4	5
FCF (\$ millions)	53	68	78	75	82

After then, the free cash flows are expected to grow at the industry average of 4% per year. Using the discounted free cash flow model and a weighted average cost of capital of 14%:

- Estimate the enterprise value of Heavy Metal.
 - If Heavy Metal has no excess cash, debt of \$300 million, and 40 million shares outstanding, estimate its share price.
- 9-22.** You notice that PepsiCo has a stock price of \$52.66 and EPS of \$3.20. Its competitor, the Coca-Cola Company, has EPS of \$2.49. Estimate the value of a share of Coca-Cola stock using only this data.

Table 9.1

Ticker	Name	Stock Price (\$)	Market Capitalization (\$ millions)	Enterprise Value (\$ millions)	P/E	Price/Book	Enterprise Value/Sales	Enterprise Value/EBITDA
KCP	Kenneth Cole Productions	26.75	562	465	16.21	2.22	0.90	8.36
NKE	NIKE, Inc.	84.20	21,830	20,518	16.64	3.59	1.43	8.75
PMMAY	Puma AG	312.05	5,088	4,593	14.99	5.02	2.19	9.02
RBK	Reebok International	58.72	3,514	3,451	14.91	2.41	0.90	8.58
WWW	Wolverine World Wide	22.10	1,257	1,253	17.42	2.71	1.20	9.53
BWS	Brown Shoe Company	43.36	800	1,019	22.62	1.91	0.47	9.09
SKX	Skechers U.S.A.	17.09	683	614	17.63	2.02	0.62	6.88
SRR	Stride Rite Corp.	13.70	497	524	20.72	1.87	0.89	9.28
DECK	Deckers Outdoor Corp.	30.05	373	367	13.32	2.29	1.48	7.44
WEYS	Weyco Group	19.90	230	226	11.97	1.75	1.06	6.66
RCKY	Rocky Shoes & Boots	19.96	106	232	8.66	1.12	0.92	7.55
DFZ	R.G. Barry Corp.	6.83	68	92	9.20	8.11	0.87	10.75
BOOT	LaCrosse Footwear	10.40	62	75	12.09	1.28	0.76	8.30
Average (excl. KCP)					15.01	2.84	1.06	8.49
Maximum					+51%	+186%	+106%	+27%
Minimum					-42%	-61%	-56%	-22%

9-23. Suppose that in January 2006, Kenneth Cole Productions had EPS of \$1.65 and a book value of equity of \$12.05 per share.



- Using the average P/E multiple in Table 9.1, estimate KCP's share price.
- What range of share prices do you estimate based on the highest and lowest P/E multiples in Table 9.1?
- Using the average price to book value multiple in Table 9.1, estimate KCP's share price.
- What range of share prices do you estimate based on the highest and lowest price to book value multiples in Table 9.1?

9-24. Suppose that in January 2006, Kenneth Cole Productions had sales of \$518 million, EBITDA of \$55.6 million, excess cash of \$100 million, \$3 million of debt, and 21 million shares outstanding.



- a. Using the average enterprise value to sales multiple in Table 9.1, estimate KCP's share price.
- b. What range of share prices do you estimate based on the highest and lowest enterprise value to sales multiples in Table 9.1?
- c. Using the average enterprise value to EBITDA multiple in Table 9.1, estimate KCP's share price.
- d. What range of share prices do you estimate based on the highest and lowest enterprise value to EBITDA multiples in Table 9.1?

9-26. Consider the following data for the airline industry in early 2009 (EV = enterprise value, BV = book value, NM = not meaningful because divisor is negative). Discuss the challenges of using multiples to value an airline.

Company Name	Market Cap	EV	EV/Sales	EV/EBITDA	EV/EBIT	P/E	P/Book
Delta Air Lines	4,799.6	16,887.6	0.7x	15.0x	NM	NM	NM
AMR Corp.	1,296.5	8,743.5	0.4x	17.5x	NM	NM	NM
JetBlue Airways	1,246.9	3,834.9	1.1x	10.4x	25.7x	NM	1.0x
Continental Airlines	1,216.8	4,506.8	0.3x	14.7x	NM	NM	NM
UAL Corp.	701.0	6,192.0	0.3x	NM	NM	NM	NM
Air Tran Holdings	651.3	1,354.7	0.5x	21.7x	NM	NM	2.3x
SkyWest	588.7	1,699.7	0.5x	3.8x	7.5x	6.5x	0.5x
Hawaiian	257.1	262.1	0.2x	1.7x	2.7x	3.6x	NM
Pinnacle Airlines	44.0	699.7	0.8x	6.6x	10.1x	3.4x	1.0x

Source: Capital IQ