LO.a: Describe characteristics of types of equity securities.

1. Which of the following statements about the key characteristics of different types of preference shares is *least accurate*?
   A. Preference shares have characteristics of both debt and equity securities.
   B. Preference shareholders rank below subordinated bondholders with respect to claims on the company's net assets upon liquidation.
   C. The price of convertible preference shares tends to be more volatile than their underlying common shares.

2. Which of the following statements is *least accurate*?
   A. Investors prefer to invest in putable common shares rather than callable common shares.
   B. The issuing company is obligated to buy callable common shares at a predetermined price.
   C. Putable common shares facilitate raising capital because of their appeal to investors over callable common shares.

3. Which of the following statements about participating preference shares is *least accurate*?
   A. They entitle shareholders to participate in additional dividends if the company's profits exceed a predetermined level.
   B. They entitle shareholders to participate in corporate decisions through voting rights.
   C. They entitle shareholders to participate in additional distribution of the company's assets upon liquidation.

LO.b: Describe differences in voting rights and other ownership characteristics among different equity classes.

4. Which of the following decisions is *least likely* to be the one which common stock holders can vote on?
   A. Auditor selection.
   B. Dividend payments.
   C. Merger decisions.

5. Common shares do not entitle investors:
   A. to a share of the company's operating performance.
   B. to participate in decision making in the form of voting rights.
   C. to fixed dividend payments.

6. In what way are preference shares similar to debt securities?
   A. Preference shareholders generally receive predictable cash flows.
   B. The dividends are usually variable like interest payments on debt securities.
   C. Preference share dividends are tax deductible.

7. The right to receive the standard preferred dividend plus an additional dividend based on some condition like if the company's profits exceed a certain level, is *best* known as what type of dividend?
   A. Cumulative.
   B. Participating.
   C. Non-participating.

8. The type of equity voting right that works in favor of minority shareholders where each shareholder gets to cast one vote per share times the number of positions to be filled is referred to as:
   A. statutory voting.
   B. proxy voting.
   C. cumulative voting.

LO.c: Distinguish between public and private equity securities.

9. Which of the following is *most likely* true for a leveraged buyout (LBO)?
   A. A company uses debt to buy back its shares.
   B. The management of a firm uses its own equity to purchase the common shares of a public company.
   C. A group of investors uses a large amount of debt to buy all outstanding common shares of public company.

10. All of the following are correct about private equity securities except:
    A. they cannot be traded on public exchanges.
    B. they trade in secondary equity markets.
    C. they are issued primarily to institutional investors.

11. Leveraged buyout investments:
    A. provide financing to start-ups and early-stage companies.
    B. require a long term commitment of funds.
    C. are publically traded.

12. Which of the following differences between private and public equity firm is incorrect?
    A. Exiting out of a private equity investment in comparison of public equity is easy as they do not trade on secondary markets.
    B. Private equity investment score low in terms of corporate governance relative to their public counterparts.
    C. Private equity firms incur lesser cost compared to public firms in regulatory and stock exchange filing requirements.

13. As compared to public equity markets, operating in the private market:
    A. offers management to better adopt a long-term focus.
    B. offers stronger incentives to improve corporate governance.
    C. allows more opportunities to raise capital.

14. The *most likely* candidates for a management buyout (MBO) are firms with:
    A. low levels of cash flow.
    B. high dividend payout ratios.
    C. large amounts of undervalued assets.

LO.d: Describe methods for investing in non-domestic equity securities.

15. A U.S. investor is looking for exposure to international stocks which trade like common shares on the New York Stock Exchange. Such instruments are called:
    A. global registered shares.
    B. global depository receipts.
    C. American depository receipts.

16. Many countries impose restrictions on foreign individual and institutional investors from investing in domestic companies. Which of the following is *least likely* a reason for this restriction?
    A. Restrictions help limit the amount of control foreign companies can exert on domestic companies.
    B. Restrictions make it easier for local companies to raise capital.
    C. Restrictions lead to higher stability of capital markets.

17. Which of the following is *most accurate* with respect to Level II listed ADR?
    A. They allow raising capital in U.S. markets through public offerings.
    B. They have no size and earning requirements.
    C. They have high listing fees.

18. The voting rights to the shares in the trust of an unsponsored depository receipt belong to:
    A. underlying foreign company whose shares are being issued.
    B. the depository bank issuing the shares.
    C. investor who purchases the shares.

19. A basket of listed depository receipts:
    A. tracks an index.
    B. cannot be shorted.
    C. cannot be purchased on margin.

20. Which of the following factors *least likely* impact the returns from a depository receipt?
    A. Company fundamentals.
    B. Market conditions.
    C. The ratio of depository receipts to underlying shares.

21. Martha comes across the following two statements while checking her students' examination papers.
    Statement I: The only disadvantage of a global depository receipt is that it is subject to capital flow restrictions.

Statement II: Sponsored depository receipts provide the investors with voting rights while unsponsored depository receipts do not.
Which of the following statements is *most accurate*?

A. Both Statements I and II are incorrect.
B. Statement I is incorrect, but statement II is correct.
C. Statement I is correct, but statement II is incorrect.

22. Which of the following statements about depository receipts (DRs) is *least* accurate?
    A. Investors in unsponsored DRs have the same voting rights as the direct owners of common shares.
    B. Investing in DRs could offer arbitrage opportunities and involve currency risk.
    C. Sponsored DRs are subject to greater reporting requirements than unsponsored DRs.

LO.e: Compare the risk and return characteristics of different types of equity securities.

23. Which of the following types of securities of a same company would *most likely* offer the lowest expected return to the investor?
    A. Common shares with no dividend policy.
    B. Non-cumulative putable preference shares.
    C. Non-cumulative callable preference shares.

24. If a Europe based investor purchases a US-dollar denominated ETF and the dollar subsequently appreciates in value relative to euro, the investor will have a total return that is:
    A. greater than ETF's total return.
    B. lesser than ETF's total return.
    C. same as ETF's total return.

25. Which of the following is incorrect about risk characteristics of preference shares?
    A. Dividend on preference shares is fixed and known.
    B. Paid before common shares.
    C. Amount to be received on liquidation is not fixed.

26. Which of the following equity securities is least risky from an investor's point of view?
    A. Cumulative preference shares.
    B. Putable preference shares.
    C. Non-callable preference shares.

27. Which of the following is *most likely* to be an advantage of a convertible preference share?
    A. Additional dividends received during profitable years.
    B. Fixed preference dividends that are contractual obligations of the company.
    C. Less price volatility than the underlying common shares.

28. Which of the following statements is *least accurate*?
    A. All else equal, investors prefer putable over callable shares.
    B. Putable shares are more difficult to sell than callable shares.
    C. The call option which is part of a callable share is a benefit to the issuer.

LO.f: Explain the role of equity securities in the financing of a company's assets.

29. Which of the following is *least likely* a main reason for a company to raise capital by issuing equity securities?
    A. To provide stock option-based incentives to employees.
    B. To satisfy working capital requirements.
    C. To finance the purchase of long-lived assets.

30. A company issues equity on a primary market:
    A. To raise capital.
    B. To increase return on capital.
    C. To increase return on equity.

31. Which of the following is a primary goal for a company to raise equity capital?
    A. To make acquisitions.
    B. To fulfil debt requirements.
    C. To finance revenue generating activities.

LO.g: Distinguish between the market value and book value of equity securities.

32. Which of the following is *least* accurate in describing company's book value?
    A. Book value increases when a company pays little or no dividend.
    B. Book value is based on what investors expect will happen in future.
    C. Market value and book value are rarely equal.

33. Which of the following statements *most likely* describes a company's book value and market value?
    A. Management can directly influence the book value and market value of the company.
    B. Decrease in book value will automatically cause a company's market value to decrease.
    C. A change in investors' expectations can impact a company's market value.

34. Given the following information-
    Number of shares outstanding = 200,000
    Price per share = $ 102
    Total assets = $ 24,000,000
    Total liabilities = $ 10,500,000
    Net Income = $ 6,000,000
    The book value of the company is *closest* to:
    A. $ 13,500,000.
    B. $ 19,500,000.
    C. $ 20,400,000.

LO.h: Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.

35. A company's ROE will *most likely* decrease, holding all other factors constant, if:
    A. net income decreases at a slower rate than the shareholders' equity.
    B. net income increases at a slower rate than the shareholders' equity.
    C. company issues debt to repurchase outstanding shares of equity.

36. What would the total return on a share of equity be if:
    Purchase price = $ 100
    Sale price = $62
    Dividend paid during holding period = $5
    A. - 53%.
    B. - 33%.
    C. - 43%.

37. Calculate the 2011 return on equity of a stable company using the following data:
    Total Sales = $ 15,000,000
    Net Income = $ 10,000,000
    Beginning of year total assets = $ 150,000,000
    Beginning of year total liabilities = $ 130,000,000
    A. 50%.
    B. 12.5%.
    C. 6.67%.

38. Which of the following situations will *least likely* lead to an increase in a company's ROE?
    A. Net income increasing at a faster rate than equity.
    B. If a company borrows to purchase its outstanding shares from the market.
    C. Market price of a company's shares increases.

39. Which of the following measures is relatively simple to calculate?
    A. Cost of debt.
    B. Cost of equity.
    C. Investor's required rate of return.

40. Azure LLC has sold off 10% of its total assets, which were unproductive since the past three years, and used the proceeds to buy back its common shares. Holding other factors constant, the *most likely* effect will be a:
    A. higher ROE.
    B. higher profit margin.
    C. lower growth rate.

41. A mutual fund manager is looking to invest in a company's stock with the following characteristics:

Risk-free rate	2.50%
Market risk premium	4.30%
Stock's beta	1.9
Manager's expected rate of return	9.55%

Company's weighted average cost of capital	9.25%

Based on this information, which of the following would be *most appropriate* investment decision for the fund manager?

A. Do not invest in stock as WACC is greater than required rate of return.
B. Do not invest in the stock because the required return is greater than the manger's expected rate of return.
C. Invest in stock.

Solutions

1. C is correct. The price of convertible preference shares tends to be less volatile than their underlying common shares because they do not allow investors to share in profits of the company and the dividends on preference shares are fixed.

2. B is correct. The issuing company has the option and is not obligated to buy callable common shares at a predetermined price.

3. B is correct. Participating preference shares do not entitle the shareholders to participate in corporate decisions through voting rights. Options A and C are correct.

4. B is correct. Common stock holders are least likely to have a say in determining the dividend payments. They receive dividends after preferred stock holders have been paid. Common stock holders can vote on issues like selection of auditors and merger decisions.

5. C is correct. The dividend payments are not fixed in common shares.

6. A is correct. Dividends are generally predictable as with coupon payments on fixed income securities.

7. B is correct.

8. C is correct. The type of equity voting right that works in favor of minority shareholders where each shareholder gets to cast one vote per share times the number of positions to be filled is referred to as cumulative voting.

9. C is correct. This is the correct definition of a leveraged buyout (LBO), which is covered in more detail in Alternative Investments.

10. B is correct. They do not trade in secondary markets.

11. B is correct. Leveraged buyout investments provide financing to established companies. These are private investments and require a long-term commitment.

12. A is correct. Exiting out of a private equity investment in comparison of public equity is tricky as they do not trade on secondary markets.

13. A is correct. Public firms are under pressure from shareholders to meet shorter-term demands. Compared to this, private firms are better able to focus on longer-term value creation opportunities.

14. C is correct. Firms with (1) large amounts of undervalued assets which can be sold to reduce debt; and (2) that generate high levels of cash flows which can be used to make interest and

principal payments on the debt are most likely candidates for management buyout transactions.

15. C is correct. American depository receipts (ADRs) meet the investor's preferences.

16. B is correct. Options A and C are reasons for investing in domestic companies. Option B is not a reason because restrictions on capital flows makes it harder (not easier) for local companies to raise capital.

17. C is correct.

18. B is correct. The bank purchases the shares, places them into a trust and then sells shares in the trust in other markets.

19. A is correct. A basket of listed depository receipts tracks an index but trades like an individual share on an exchange.

20. C is correct. The price of each depository receipt (and returns) will be affected by factors that affect the price of the underlying shares, such as company fundamentals, market conditions, analysts' recommendations, and exchange rate movements. The ratio of depository receipts to underlying shares does not impact return.

21. B is correct. Global depository receipts are *not* subject to capital flow restrictions. Therefore statement I is incorrect. Statement II is correct.

22. A is correct. Investors of unsponsored DRs do not have voting rights, the depository bank retains the voting rights.

23. B is correct. Putable preference shares are less risky than their callable counterparts. They give the investor the option to put the shares back to the company. Because of the lower risk they will provide a lower expected rate of return. Common shares are the most risky, whether or not they are dividend paying, and are likely to offer the highest expected return.

24. A is correct. Currency appreciation will add additional gain which will make investor's total return greater than ETF's total return.

25. C is correct. Amount to be received on liquidation is fixed, equal to par value of the shares.

26. B is correct. Putable preference shares are least risky as they give the investor an option to sell the shares back to the issuer at a pre-determined price. This pre-determined price creates a floor for the share's price that reduces the uncertainty of future cash flow of investors.

27. C is correct. Convertible preference shares tend to exhibit less price volatility than the underlying common shares because the dividend payments are known and more stable.

28. B is correct. Options A and C are correct. Option B is not true. Just because a share is putable or callable does not make it any easier to sell.

29. B is correct. A and C represent reasons for why a company might raise capital by issuing equity. It is unlikely that a company will finance working capital requirements by issuing equity.

30. A is correct. A company issues equity on a primary market to raise capital and increase liquidity.

31. C is correct. To finance revenue generating activities (organic growth).The capital is used to purchase long-term assets, invest in profit-generating projects, expand to new territories, or invest in research and development.

32. B is correct. Book value is based on current value of assets and liabilities.

33. C is correct.

34. A is correct. Book value = Total assets – Total liabilities = $\$\ 24{,}000{,}000 - \$\ 10{,}500{,}000$ = $ 13,500,000.

35. B is correct. An increase in net income at a slower rate than shareholders' equity will cause the ROE to decrease as denominator increases faster than the numerator.

36. B is correct. Total return= $\frac{P_t - P_{t-1} + D_t}{P_{t-1}} = \frac{62-100+5}{100}$ = - 33%.

37. A is correct. ROE = $\frac{\$10{,}000{,}000}{\$20{,}000{,}000}$ = 50%

38. C is correct. Increase in the market price of a company's shares has no effect on ROE.

39. A is correct. It is relatively simple to calculate the cost of debt – the interest or coupon the company is obligated to pay its bondholders is the cost it incurs.

40. A is correct. Selling unproductive assets and using the proceeds from the sale to buy back shares reduces the total assets. Holding sales constant the decrease in assets would improve the asset turnover. Buying back shares increases the firm's financial leverage. Both the increase in asset turnover and financial leverage will lead to a higher return on equity.

41. B is correct.

Stock's required return according to CAPM = $\text{risk free rate} + \text{beta} * \text{market risk premium}$ = $0.025 + 1.9 * 0.043$ = 10.67%. Since the stock's required return (10.67%) is greater than the expected rate of return (9.55%), the correct decision is to not invest.