Mergers and Acquisitions

Test ID: 7440579

Question #1 of 102

Question ID: 462867

A spin-off differs from a sale in that a spin-off involves:

- ✗ **A) an exchange of the parent's shares for shares of the subsidiary.**
- ✗ **B)** the divestiture of the subsidiary for cash.
- ✓ **C)** the distribution of shares in the subsidiary to the parent's existing shareholders.

Explanation

Both a spin-off and a sale involve the divestiture of a subsidiary or some coherent subset of the firm's assets. In the case of a spin-off, the divestiture involves the distribution of the new firm's shares to the parent's existing shareholders. In the case of a sale, the divestiture is for cash.

Question #2 of 102

Question ID: 462773

A combination of two firms in the same line of business is called a:

- ✗ **A) congeneric merger.**
- ✓ **B)** horizontal merger.
- ✗ **C)** vertical merger.

Explanation

A combination of two firms in the same line of business is a horizontal merger.

Question #3 of 102

Question ID: 462872

Insofar as reasons for divestitures are concerned, when a firm divests of assets because of rising costs or a change in consumer tastes, this is *most* consistent with the rationale of:

- ✗ **A) assets no longer fitting the long-term strategy.**
- ✓ **B)** a lack of profitability.
- ✗ **C)** individual parts are worth more than the whole.

Explanation

Changes in consumer tastes imply that sales are below expectations, while rising costs are self-explanatory. In either case, this seems to indicate that profitability objectives are not being met.

Question #4 of 102

Question ID: 462793

When Firm A acquires Firm B, and, even though there are no real economic gains resulting from the merger, Firm A's earnings per share increase, this is called:

- ✗ **A)** **compression.**
- ✓ **B)** bootstrapping.
- ✗ **C)** synergies.

Explanation

When a firm acquires another firm and its earnings per share increase, even though there are no economic gains from the merger, this is called earnings per share bootstrapping.

Question #5 of 102

Question ID: 462767

A conglomerate is *most likely* to participate in which type of merger?

- ✓ **A)** **Diversifying merger.**
- ✗ **B)** Vertical merger.
- ✗ **C)** Horizontal merger.

Explanation

Conglomerates by definition invest in unrelated business lines.

Question #6 of 102

Question ID: 462829

Which of the following statements concerning valuation using discounted cash flow analysis of takeover candidates is *least* accurate?

- ✗ **A)** **An advantage is that the estimate is based on forecasts of fundamental conditions in the future rather than on current data.**
- ✓ **B)** A disadvantage is that the model is difficult to customize.
- ✗ **C)** A disadvantage is that the model is difficult to apply when free cash flows are negative.

Explanation

An advantage of the discounted cash flow valuation approach is that the model is relatively easy to customize. Both remaining statements are correct as presented.

Question #7 of 102

Question ID: 462851

Which of the following statements concerning the gains from a merger are *least* accurate?

- ✓ **A)** **In a stock offer, the target shareholder's gains are less than those from a comparable cash offer.**

✗ **B)** In a stock offer, gains to the target shareholders are dependent upon the post-merger stock price of the acquirer.

✗ **C)** In a cash offer, the target shareholder's gains are capped at the amount of the takeover premium.

Explanation

In a stock offer, the target shareholder's gains will generally exceed those from a comparable cash offer. This, of course, depends upon the acquirer's stock price following the merger. But, if the exchange ratio is based upon the acquirer's pre-merger price, and if the post-merger price exceeds the pre-merger price, the target's gains from the stock offer should be greater than those from a cash offer.

Question #8 of 102

Question ID: 472530

Which of the following is *most likely* to be used to describe a merger between competitors?

✗ **A)** **Vertical merger.**

✗ **B)** Conglomerate merger.

✓ **C)** Horizontal merger.

Explanation

Horizontal mergers involve companies in the same line of business; generally competitors.

Question #9 of 102

Question ID: 462830

Which of the following statements concerning valuation using comparable company analysis of takeover candidates is *least* accurate?

✗ **A)** **A disadvantage is that it is difficult to incorporate merger synergies or changing capital structures into the analysis.**

✓ **B)** An advantage is that the approach implicitly assumes that the market's valuation of the comparable companies is accurate.

✗ **C)** An advantage is that data for comparable companies is usually easy to access.

Explanation

The fact that the approach implicitly assumes that the market's valuation of the comparable companies is accurate is a disadvantage if the assumption is not correct. Both remaining statements are correct as presented.

Question #10 of 102

Question ID: 462813

When the target of an unwanted takeover turns the table and attempts to take over the firm attempting to acquire it, this is a:

✗ **A)** **post-offer defense and is called the white squire defense.**

✓ **B)** post-offer defense and is called the pac-man defense.

✗ **C)** post-offer defense and is called greenmail.

Explanation

When the target of a takeover turns the table and attempts to take over the firm making the offer, this is called a pac-man defense. This is a post-offer defense.

Question #11 of 102

Question ID: 462772

If a firm combines with one of its suppliers or customers, it is called a:

✗ **A)** **conglomerate merger.**

✗ **B)** horizontal merger.

✓ **C)** vertical merger.

Explanation

When a firm merges with a supplier or customer, it is a vertical merger.

Question #12 of 102

Question ID: 462868

When a parent company sells a subsidiary or a coherent group of assets with a stated reason to provide a near-term infusion of cash, which method for selling the assets is *most likely*?

✓ **A)** **Divestiture.**

✗ **B)** Equity carve-out.

✗ **C)** Spin-off.

Explanation

Spin-offs involve the issuance of shares in the new firm, and do not generate cash for the parent company. Hence, this can be ruled out if the intent is an infusion of cash. An equity carve-out will generate cash for the parent when the public offering is completed, but this can take time. A divestiture is typically a sale to another firm for cash, and is likely to be completed much more quickly than a carve-out. Therefore, if the intent is to provide a near-term infusion of cash, a divestiture is most likely.

Question #13 of 102

Question ID: 462835

Which of the following orderings is the *most* accurate with regard to the steps involved in valuation using comparable transaction analysis?

✓ **A)** **Identify recent takeovers of comparable companies, calculate relative value measures, apply relative value measures to target firm.**

✗ **B)** Identify recent takeovers of comparable companies, calculate relative value measures, apply relative value measures to target firm, estimate takeover premium, estimate takeover price.

✗ **C)** Identify comparable companies, calculate relative value measures, apply relative value measures to target firm, estimate takeover premium, estimate takeover price.

Explanation

The correct ordering is: identify recent takeovers of comparable companies, calculate relative value measures, apply relative value measures to target firm. Identifying comparable companies is not correct by itself because they need to have been taken over. There is no need to estimate the takeover premium because this will be present in the relative value measures for firms that have been taken over.

Question #14 of 102

Question ID: 462781

Merger synergies are usually realized from:

✗ **A)** **increasing market share.**

✗ **B)** merger tax benefits.

✓ **C)** decreasing costs and/or increasing revenues.

Explanation

The existence of synergies typically result in decreases in costs for the combined firm (e.g., the same distribution network can support both firms' retail networks) and/or an increase in revenues (e.g., by cross-selling product lines). Both remaining responses are motivations for M&A activities, but do not result from the realization of synergies.

Question #15 of 102

Question ID: 462865

Based upon short-term stock performance around the merger date, academic studies concerning the distribution of the benefits suggest that:

✗ **A)** **the target usually loses value, but the acquirer usually gains value.**

✓ **B)** the acquirer usually loses value, but the target usually gains value.

✗ **C)** both parties usually gain value.

Explanation

Studies based upon short-term stock performance around the merger date suggest that the acquirer loses a small amount of value, while the target makes significant gains.

Question #16 of 102

Question ID: 462779

Which of the following is *least likely* a criticism of merging purely for diversification purposes?

✗ **A)** **Diversification does not increase the overall value of the company.**

✓ **B)** Increasing the size of the firm helps provide job security for management.

✗ **C)** Empirical evidence finds a diversification discount to conglomerates.

Explanation

Increasing the size of the firm does not necessarily benefit shareholders, but it would not be considered a valid criticism. Increasing the size of the firm is a potential benefit for managers because diversification reduces the threat of a takeover, and helps management further secure their employment. Both remaining reasons stated are each valid criticisms of a diversification merger.

Questions #17-22 of 102

Gazelle Bancorp was formed 11 years ago to address what its founders deemed unmet consumer needs. Apparently, they were correct in their assessment, and Gazelle has grown rapidly as a niche player. This has attracted the attention of the other banks in its market, and rumors are swirling that two of its competitors are contemplating takeover bids for Gazelle. The firm's management has approached Omega Financial for advice on strategies it can employ should the firm become a takeover target.

Ionnias Padras, CFA, has been assigned as the lead advisor to Gazelle's management. In advance of their initial meeting, he has prepared a list of questions and discussion points. With this information he hopes to built a coherent strategy either to fend off the potential suitors or to realize maximum value for Gazelle's shareholders, should a takeover be consummated.

During the course of his meeting with management, Padras asks the bank managers a series of questions, and the answers he received are provided below each question.

> Q1: What is your growth rate, and how does it compare to your potential acquirers?
> *A1: Our profits have been growing at a rate of approximately 10% per year, while our potential acquirers' profits have been growing in line with the overall economy, which is about 3 to 4% per year.*
>
> Q2: Do you have any takeover defenses in place, and, if so, what are they?
> *A2: We have established a set of compensation arrangements to enhance management's security. If a merger were to occur, our top 7 management personnel would each be paid 4 years salary. This is contingent upon the managers agreeing to remain in their jobs until the merger is completed.*
>
> Q3: How many banks are operating in the market, and what are their market shares?
> *A3: There are 11 other comparable financial institutions in our market. 8 of these institutions have a market share of 6% each, 3 of them have a market share of 15% each, and we have a share of 7%. Potential acquirer 1 has a share of 15%, while potential acquirer 2 has a share of 6%.*
>
> Q4: Do you consider any of your current competitors similar to Gazelle? Were there other banks previously present in the market that have been taken over recently?
> *A4: None of the current competitors have business models or growth rates that are comparable to Gazelle. There are three previously independent institutions that have business models and growth rates similar to ours, and are our direct competitors. These banks were taken over by other banks within the past 3 years.*
>
> Q5: What is Gazelle's current market price and how many shares are outstanding? If your firm were to merge with either of its potential suitors, what is your estimate of the synergies available? Is there any chance that

> your board would agree to a takeover if the price were right?
> *A5: Our current share price is $43, and there are 50 million shares outstanding. We estimate that the present value of potential cost reductions and revenue enhancements for an acquirer would be approximately $500m. The board can probably be convinced to accept an offer it believes to be adequate.*
>
> Q6: Describe the structure of your banking operations. Is there any other course of action that you would consider that might make the bank less attractive as a takeover target?
> *A6: Gazelle is a combination of a traditional, full service bank, and a 24/7 provider of personal financial services. For example, we have been able to obtain exclusive agreements with the 2 largest grocery chains in our market to open branch offices in their stores. We have similar agreements with other 24/7 retail establishments, and consumers have found the ability to bank at any time of the day extremely attractive. We believe that this is the part of Gazelle that our prospective suitors are seeking.*

Question #17 of 102

Question ID: 462822

Based upon the information provided to Padras, does it appear that the potential suitors are seeking to bootstrap their earnings? What stage of the industry lifecycle is Gazelle *most* likely in?

	Bootstrap Earnings	Industry Life Cycle
✗ A)	**Yes**	**Rapid growth**
✗ B)	No	Rapid growth
✓ C)	No	Mature growth

Explanation

In order for bootstrapping to occur, a high price-to-earnings (P/E) firm needs to acquire a low P/E firm. In this case, based upon the relative growth rates, the opposite is likely to be true. Gazelle is most likely in the mature growth stage. In this stage, competition is present, but there is still opportunity for above average growth. During the rapid growth stage, competition is more limited than appears to be the case for Gazelle. (Study Session 9, LOS 29.d)

Question #18 of 102

Question ID: 462823

What type of take-over defense does Gazelle have in place, and is this likely to be sufficient to fend off a potential suitor?

	Take-Over Defense	Defense Sufficient?
✗ A)	**Greenmail**	**No**
✓ B)	Golden parachute	No
✗ C)	Golden parachute	Yes

Explanation

The company has a golden parachute package in place. If the compensation for the top 7 managers averaged $500,000, the total cost of the golden parachute is $14m. This is probably not sufficient to deter a bidder. Conversely, to the extent that it helps keep management in place during the acquisition, it may make Gazelle more attractive as an acquisition candidate. (Study Session 9, LOS 29.f)

Question #19 of 102

Question ID: 462824

If both of the prospective acquirers were to make bids, what are the probable antitrust ramifications for potential acquirer 1 and potential acquirer 2, respectively?

✗ **A)** **Antitrust action virtually certain because change in HHI is greater than 100; small chance of antitrust action because change in HHI is less than 50.**

✓ **B)** Good chance of antitrust action because change in HHI is greater than 100; small chance of antitrust action because change in HHI is less than 100.

✗ **C)** No chance of antitrust action because change in HHI is less than 100; no chance of antitrust action because change in HHI is less than 50.

Explanation

Based upon the market share data provided, the initial HHI value is:

$$HHI = (15^2 \times 3) + (6^2 \times 8) + (7^2 \times 1) = 1012$$

If acquirer 1 were successful, the new HHI = 1222 (an increase of 210). This indicates a good chance of an antitrust challenge. If acquirer 2 were successful, the new HHI = 1096 (an increase of 84). This indicates a small chance of an antitrust challenge. (Study Session 9, LOS 29.g)

Question #20 of 102

Question ID: 462825

Based upon the information provided, what type of valuation methodology is *most* likely to be used by the potential acquirers?

✗ **A)** **Discounted cash flow.**

✗ **B)** Comparable firm.

✓ **C)** Comparable transaction.

Explanation

Since there are no comparable direct competitors in the market, *comparable firm analysis* is unlikely. *Discounted cash flow analysis* is a viable possibility. However, given that there have been 3 comparable transactions over the past 3 years, this argues strongly in favor of a *comparable transaction* valuation methodology. (Study Session 9, LOS 29.h)

Question #21 of 102

Question ID: 462826

What is the probable price range for an offer for Gazelle? If one of the acquirers makes an offer of $55, should the board accept it?

	Price Range	Accept
✗ **A)**	**$43 to $53**	**No**
✓ **B)**	$43 to $53	Yes
✗ **C)**	$43 to $63	Yes

Explanation

The probable price range is the current market price to the current price + the value of the synergies. That is, $43 to $43 + 500m / 50m = $53. If they receive an offer greater than $53, the board should accept. (Study Session 9, LOS 29.k)

Question #22 of 102

Question ID: 462827

If Gazelle were to separate itself into two parts, the traditional bank and the 24/7 bank, and to sell off the 24/7 bank in a public offering, what would the action be called from the standpoint of the sale and from the standpoint of a takeover defense?

	Sale	Takeover Defense
✗ A)	**Equity carve-out**	**Leveraged recapitalization defense**
✓ B)	Equity carve-out	Crown jewel defense
✗ C)	Split-off	Crown jewel defense

Explanation

A public offering of a subsidiary as a stand-alone enterprise is called an equity carve-out. Using this technique to fend off a merger is known as a crown jewel defense. (Study Session 9, LOS 29.n)

Question #23 of 102

Question ID: 462811

During negotiations over the method of payment to be made by the acquirer, which of the following issues would *least likely* be considered?

✗ A) **The distribution of the risk and reward from the transaction.**

✓ B) The relative tax-effect on the acquiring firm's shareholders.

✗ C) The relative valuations of the firms involved.

Explanation

The method of payment is not likely to have any direct tax-effect on the acquiring firm's shareholders, but may on the target's shareholders. Both remaining answers are issues that should be considered during the determination of payment method.

Question #24 of 102

Question ID: 462837

An analyst has identified three companies that they believe are comparable to a firm under evaluation as a takeover candidate. The relative value measures they have selected are price-to-earnings (P/E) and price-to-cash flow (P/CF). The market price, earnings per share, and cash flow per share, for each company, respectively, are:

	Market Price	**EPS**	**CF per Share**
Company A	55	4.80	6.26
Company	129	10.40	13.75

B			
Company C	19	1.80	2.10

What values for these ratios should be applied to the target firm?

✓ **A) P/E = 11.5x, P/CF = 9.1x.**

✗ **B)** P/E = 11.9x, P/CF = 9.0x.

✗ **C)** P/E = 12.5x, P/CF = 8.9x.

Explanation

$$P/E = \frac{11.5 + 12.4 + 10.6}{3} = 11.5$$

$$P/CF = \frac{8.8 + 9.4 + 9.0}{3} = 9.1$$

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Question ID: 462831

Gambit Enterprises is being evaluated as an acquisition target. An analyst believes that the firm will have free cash flow (FCF) of $500m during year 5, after which the growth rate in FCF is expected to be 4% indefinitely. The weighted average cost of capital (WACC) for Gambit is 10%. What is the estimated value of the firm at the end of year 5?

✗ **A) $8333m.**

✗ **B)** $9167m.

✓ **C)** $8667m.

Explanation

Value at end of year 5 = (FCF year 5 × (1 + g)) / (WACC - g)
Value at end of year 5 = (500 × 1.04) / (0.10 - 0.04) = $8667m

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Question #26 of 102

Question ID: 462777

Which of the following is NOT a commonly used merger classification describing forms of integration?

✓ **A) Regulatory merger.**

✗ **B)** Subsidiary merger.

✗ **C)** Consolidation.

Explanation

Regulatory merger is not a commonly used merger classification. Both remaining answers are commonly used to describe the form of integration following a merger.

Question #27 of 102

Question ID: 462780

Achieving international business objectives is sometimes used as the rationale for a merger. Which of the following are *least* likely to be valid objectives that can be realized from a cross-border merger? The merger:

- ✓ **A) achieves a reduction in exchange rate exposure.**
- ✗ **B)** gives the acquiring firm the ability to use technology in new markets.
- ✗ **C)** provides the ability to work around trade barriers.

Explanation

In general, a cross-border merger is likely to increase the acquiring firm's exchange rate exposure. Both remaining statements are valid arguments in support of a cross-border merger.

Question #28 of 102

Question ID: 462794

Use the following data to calculate the EPS of the combined firm following the merger. Topeka Industries has EPS of $4.00, a market price of $90 per share, and 500,000 shares outstanding. Omaha Company has EPS of $2.00, a market price of $25, and 500,000 shares outstanding. If Topeka acquires Omaha in an all-stock transaction, what is the EPS of the combined company?

- ✗ **A) $3.00.**
- ✗ **B)** $3.57.
- ✓ **C)** $4.70.

Explanation

The total value of Omaha is $25 × 500,000 = $12,500,000. Topeka will need to issue 12,500,000 / 90 = 138,889 new shares to acquire Omaha. The combined firm will have total earnings of ($4 × 500,000) + ($2 × 500,000) = $3,000,000. The combined firm will have EPS = $3,000,000 / (138,889 + 500,000) = $4.70. Note that the pre-merger P/E ratio for Topeka was 90 / 4 = 22.5, vs. 25 / 2 = 12.5 for Omaha.

Question #29 of 102

Question ID: 462818

In the advanced widget industry, there are 10 firms, each with the same market share. Two of the firms are contemplating a merger. What is the likely antitrust action, and which U.S. federal regulatory agency is responsible for taking any action deemed necessary?

- ✗ **A) Certain challenge; Federal Trade Commission.**
- ✓ **B)** Possible challenge; Federal Trade Commission.
- ✗ **C)** Possible challenge; Commerce Department.

Explanation

Before the merger, the HHI is 1000. After the proposed merger, the HHI would be 1200. The value and the magnitude of the change indicate that a challenge is possible, but not certain. The Federal Trade Commission, along with the Department of Justice, is responsible for reviewing and approving/challenging proposed mergers.

Question #30 of 102

Question ID: 462871

Insofar as reasons for divestitures are concerned, when a firm divests of assets because of reverse synergies, this is *most* consistent with the rationale of:

✗ **A) assets no longer fitting the long-term strategy.**

✗ **B)** a lack of profitability.

✓ **C)** individual parts being worth more than the whole.

Explanation

Whereas synergies imply that the whole is worth more than the sum of the parts, reverse synergies imply that the whole is worth less than the sum of the parts. Therefore, the firm is better off selling the parts to which this applies because they are worth more separately than they are as a part of the firm.

Question #31 of 102

Question ID: 462861

The theoretical price range for a merger transaction is between the pre-merger price of the target (V_T), and:

✓ **A) V_T + synergies resulting from the merger.**

✗ **B)** V_T + synergies resulting from the merger - the takeover premium.

✗ **C)** V_T + the takeover premium.

Explanation

Assuming that the true intrinsic values and synergies from the takeover can be correctly estimated, the theoretical price range for a merger transaction is between a low of the pre-merger price of the target (V_T), and a high of V_T + synergies resulting from the merger. At the low, all of the gains from the merger accrue to the acquirer. At the high, all of the gains accrue to the target.

Question #32 of 102

Question ID: 462860

Oak Industries is considering making a bid for Tidy Trim Makers. The following data applies to the analysis:

	Oak Ind.	Tidy Trim
Pre-merger stock price	$55	$80
Number of shares outstanding	400m	20m
Pre-merger market value	$22,000m	$1,600m
Estimated synergies	$700m	

If Oak Industries is confident that the merger synergies will be at least $700m or greater, the merger price should be between:

✗ **A) $1,600m and $2,300m and be paid for with stock.**

✓ **B)** $1,600m and $2,300m and be paid for with cash.

✗ **C)** $700m and $2,300m and be paid for with cash.

Explanation

The merger price should fall within the range of the pre-merger value of the target ($1,600m) and the pre-merger value plus the estimated synergies ($2,300m). Since the acquirer is confident that the synergies will be $700m or greater, they will most likely seek to pay in cash so that they capture any upside for themselves.

Question #33 of 102

Question ID: 462873

Regarding divestitures as corporate restructuring, when a firm divests of assets because of a desire to focus on its core business, this is *most* consistent with the rationale of:

✗ **A)** **individual parts being worth more than the whole.**

✓ **B)** assets no longer fitting the long-term strategy.

✗ **C)** lack of profitability.

Explanation

A stated desire to focus on the firm's core business indicates that the assets being sold are not a part of the core business. Thus, the assets no longer fit the long-term strategy.

Question #34 of 102

Question ID: 462768

A combination of two firms in entirely different industries is called a:

✗ **A)** **vertical merger.**

✗ **B)** horizontal merger.

✓ **C)** conglomerate merger.

Explanation

When two firms in entirely different industries merge, it is called a conglomerate merger.

Question #35 of 102

Question ID: 462809

When the attitude of the target firm's management is unfriendly with regard to the proposed merger, which of the following statements is *most* accurate? The offer is said to be:

✗ **A)** **antagonistic, and the acquirer can resort to a proxy battle to persuade the target firm's shareholders, or a tender offer to replace members of the target's board of directors.**

✓ **B)** hostile, and the acquirer can resort to a tender offer to the target firm's shareholders, or a proxy battle to replace members of the target's board of directors.

✗ **C)** hostile, and the acquirer can resort to a proxy battle to persuade the target firm's shareholders, or a tender offer to replace members of the target's board of directors.

Explanation

If the acquirer persists in pursuing a merger when the target's management is unfriendly to the concept, the offer is said to be hostile. In such a case, the acquirer generally attempts to go around management and negotiate with the shareholders of the target directly. This usually takes the form of a tender offer to purchase the target's stock from existing shareholders, or a proxy contest in which the acquirer seeks to convince the target's shareholders to replace the board of directors with a slate more friendly to the concept of merging with the acquirer.

Question #36 of 102

Question ID: 462814

A takeover defense that allows the firm's existing shareholders to purchase additional shares of the company's stock at attractive prices is a:

✓ **A)** **pre-offer defense and is called a poison pill.**

✗ **B)** pre-offer defense and is called a poison put.

✗ **C)** post-offer defense and is called greenmail.

Explanation

When the firm's existing shareholders are allowed to purchase additional shares of stock at a significant discount to the current market price in an attempt to thwart a takeover, this is called a poison pill defense. This is a pre-offer defense.

Question #37 of 102

Question ID: 462782

Which of the following statements concerning M&A activity is *most* accurate? Mergers based upon a desire to diversify usually do:

✗ **A)** **not make sense from the shareholders' standpoint, and do not make sense from the management's standpoint.**

✓ **B)** not make sense from the shareholders' standpoint, but may make sense from the management's standpoint.

✗ **C)** make sense from the shareholders' standpoint, and also usually make sense from the management's standpoint.

Explanation

Mergers predicated upon the need to diversify are usually not sensible from the shareholders' perspective, because they can easily diversify their investments by holding shares in multiple firms. Such mergers may make sense for management, because compensation is often positively correlated with firm size.

Question #38 of 102

Question ID: 462783

Which of the following motives for mergers *least likely* makes economic sense?

✗ **A)** **Surplus funds and vertical integration.**

✓ **B)** Diversification and reduced borrowing costs.

✗ **C)** Complementary resources and eliminating inefficiencies.

Explanation

Diversification does not make economic sense for company shareholders. It is much easier and cheaper for the shareholders to diversify simply by investing in the shares of unrelated companies themselves rather than expend the time and resources necessary to go through a merger. Similarly, merging to simply reduce financing costs is a misplaced argument since the lower cost of debt financing arises because of the greater security afforded bondholders.

Question #39 of 102

Question ID: 462850

Big Steel is considering making a bid for Small Steel. The following data applies to the analysis:

	Big Steel	Small Steel
Pre-merger stock price	$75	$100
Number of shares outstanding	500m	40m
Pre-merger market value	$37,500m	$4,000m
Estimated synergies	$600m	

If Big Steel buys Small Steel by exchanging 1.45 shares of its stock for each share of Small Steel, what are the gains to Big Steel and Small Steel, respectively?

	Big Steel	Small Steel
✓ **A)**	**$223.9m**	**$376.1m**
✗ **B)**	$100.8m	$491.3m
✗ **C)**	$246.2m	$353.8m

Explanation

Value after takeover = $37,500 + $4,000 + $600 = $42,100m.
Shares exchanged for Small Steel = 1.45 × 40m = 58m.
Post-takeover share price = value after takeover / shares outstanding = 42,100m / 558m = $75.45.
Takeover price = number of shares to small steel × post-takeover share price = 58m × $75.45 = $4,376.1m.
Gains to Small Steel = takeover premium = $4,376.1 - $4,000 = $376.1m.
Gains to Big Steel = synergies - takeover premium = $600 - $376.1 = $223.9m.

Question #40 of 102

Question ID: 462838

Which of the following orderings is *most* accurate with regard to the steps involved in valuation using comparable company analysis?

✗ **A) Identify comparable companies, apply value measures to target firm, calculate relative value measures, estimate takeover premium, and calculate the estimated takeover price.**

✗ **B)** Calculate relative value measures, identify comparable companies, apply value measures to target firm, estimate takeover premium, and calculate the estimated takeover price.

✓ **C)** Identify comparable companies, calculate relative value measures, apply value measures to target firm, estimate takeover premium, and calculate the estimated takeover price.

Explanation

The correct ordering is identify comparable companies, calculate relative value measures, apply value measures to target firm, estimate takeover premium, and calculate the estimated takeover price. Note that the estimation of the takeover premium could be done at any point prior to the final step, but the other four steps are sequential.

Question #41 of 102

Question ID: 462828

Which of the following statements concerning valuation using comparable transaction analysis of takeover candidates is *least* accurate?

✗ **A) An advantage is that estimates of value are derived directly from actual transactions, rather than from assumptions and estimates about the future.**

✓ **B)** A disadvantage is that since the approach uses data from actual transactions, it can be difficult to estimate the takeover premium.

✗ **C)** An advantage is that by using real transactions data as the basis of evaluation, the risk of future litigation concerning the proposed takeover price is reduced.

Explanation

The fact that the approach uses data from actual transactions is an advantage, since it is not necessary to estimate the takeover premium. Both remaining statements are correct as presented.

Question #42 of 102

Question ID: 462841

The quick change oil industry has been in a consolidation phase for about a decade, during which time the number of firms has shrunk from more than 50 to 15. An analyst is evaluating one of the remaining 15 firms as an acquisition target, and has come up with the following estimated acquisition prices:

Methods of Analysis	Price per Share
Discounted CF	\$50
Comparable Company	\$48
Comparable Transaction	\$57

Under the circumstances, which of these estimates is *most likely* to represent the ultimate acquisition cost, and why?

✗ **A) Discounted cash flow (CF), because this considers expectations for the future as well as current data.**

✗ **B)** Comparable company, because there is a large enough sample to ensure that valuation is correct, on average.

✓ **C)** Comparable transaction, because a sufficient number of transactions have occurred for intrinsic value to be relatively well-understood by market participants.

Explanation

Given the large number of acquisitions that have occurred in the industry, comparable transaction is likely to provide the most reliable estimate of the ultimate acquisition price. Comparable company analysis is certainly a viable method to estimate value, but still requires the analyst to estimate the takeover premium. This step is unnecessary when using the comparable transaction approach. Discounted CF valuation is also a viable method, but, in the presence of numerous comparable firms and transactions, logic suggests that the market-based valuation provided by the comparable transaction approach is more likely to produce superior results.

Question #43 of 102

Question ID: 462819

The three broad index value categories for the post-merger competitiveness of an industry, based upon the Herfindahl-Hirschman Index, are:

✗ **A)** **Less than 1000, between 1000 and 2000, and greater than 2000.**

✓ **B)** Less than 1000, between 1000 and 1800, and greater than 1800.

✗ **C)** Less than 900, between 900 and 1800, and greater than 1800.

Explanation

The three broad value categories for the post-merger competitiveness of an industry, based upon the HHI index are less than 1000 (competitive), between 1000 and 1800 (moderately concentrated), and greater than 1800 (highly concentrated).

Question #44 of 102

Question ID: 462817

Froogal Inc. operates in an industry where the current Herfindahl-Hirschman Index (HHI) is at 1,500. The company is considering merging with a competitor that would increase the HHI by 75. Is the merger likely to attract anti-trust action?

✓ **A)** **No, because the industry pre-merger is considered moderately concentrated and the change in the HHI is less than 100.**

✗ **B)** Not enough information about the number of competitors.

✗ **C)** Yes, because the industry pre-merger is considered highly concentrated and the change in HHI is greater than 50.

Explanation

If the post-merger HHI is less than 1,000, the industry is considered competitive and an antitrust challenge is unlikely. A post-merger HHI value between 1,000 and 1,800 will place the industry in the *moderately concentrated* category. In this case, regulators will compare the pre-merger and post-merger HHI. If the change is greater than 100 points, the merger is likely to be challenged on antitrust grounds. A post-merger HHI calculation greater than 1,800 implies a highly concentrated industry. Regulators will again compare the pre-merger and post-merger HHI calculations, but in this case, if the change is greater than 50, the merger is likely to be challenged.

Question #45 of 102

Question ID: 462806

When an industry has reached the stabilization stage, the *most* common type of merger is:

✗ **A) vertical.**

✗ **B)** conglomerate.

✓ **C)** horizontal.

Explanation

In the stabilization stage, companies typically seek mergers to improve economies of scale. Horizontal mergers are the most common as stronger companies acquire weaker companies to expand market share and reduce costs.

Question #46 of 102

Question ID: 462842

An analyst has identified three companies that have recently been taken over which they believe are comparable to a firm under evaluation as a takeover candidate. The relative value measures that they have selected are the price-to-earnings (P/E) and price-to-cash flow (P/CF), and the average values of these ratios are 11.2 and 8.6. The target firm has earnings per share of $2.45, and cash flow per share of $3.05. What is the estimated takeover price per share?

✓ **A) $26.84.**

✗ **B)** $27.44.

✗ **C)** $26.23.

Explanation

The estimated value based upon P/E is $27.44 = (2.45 × 11.2).
The estimated value based upon P/CF is $26.23 = (3.05 × 8.6).
The estimated takeover price is the average of these two values: $26.84.

Question #47 of 102

Question ID: 462804

The Larson Trust holds a broad portfolio of firms. One of the Trust's holdings, Music World, is growing at roughly the same, or slightly slower rate as the overall economy. The Trust is considering selling the firm. What stage of the industry lifecycle is Music World most likely in, and which method of selling the firm is *most* probable?

✗ **A) Stabilization phase, equity carve-out.**

✗ **B)** Decline phase, divestiture.

✓ **C)** Stabilization phase, divestiture.

Explanation

Music World appears to be in the stabilization phase, as it is growing at approximately the same rate as the overall economy. If it were in the decline phase, growth would be negative. Divestiture, most likely to a firm in a similar line of business, is more likely than an equity carve-out. A divestiture would allow the buyer to consolidate market share. An equity carve-out would involve a public offering of shares with only marginal attractiveness as a stand-alone enterprise.

Question #48 of 102

Question ID: 462778

Grogan Medical Devices (GMD) is a leading manufacturer of cardiac treatment devices including defibrillators and pacemakers. Over the last three months, problems have been discovered with a GMD defibrillator model, resulting in a massive product recall. As a result of the recall, and the potential impact on future sales, the price of GMD's stock dropped to its current level of $18 per share.

As a result of the drop in the price of the stock, two firms have expressed interest in acquiring GMD. Paulsgrove Corporation (Paulsgrove) is a large health care conglomerate with businesses in consumer products, pharmaceuticals, and cardiac treatment devices. The management team at Paulsgrove sees a merger with GMD as a means to combine its current defibrillator and pacemaker operations with those of GMD, creating the worldwide leader in those two product lines.

Bailey Scientific (Bailey) is a specialty manufacturer of stents used to open clogged arteries during heart surgery. Bailey sees a merger with GMD as a natural extension of its existing heart treatment product line, and believes using its existing stent product specialists to also market defibrillators and pacemakers could result in significant cost savings. They also believe that there would be benefits from expanding the size of Bailey's operations.

What would be the *best* description of the type of merger if GMD were to merge Paulsgrove or if GMD were to merge with Bailey respectively?

		Merger with Paulsgrove	Merger with Bailey
✗	A)	**Horizontal merger**	**Vertical merger**
✗	B)	Conglomerate merger	Horizontal merger
✓	C)	Horizontal merger	Horizontal merger

Explanation

Either a merger with Paulsgrove or a merger with Bailey would be described as a horizontal merger. In a horizontal merger, the two businesses operate in the same or similar industries. Even though Paulsgrove is already a conglomerate firm, the purpose of the merger would be to combine Paulsgrove's existing defibrillator and pacemaker business with that of GMD. A merger with Bailey would also be considered a horizontal merger as the two firms operate in similar industries. Note that the primary benefit for either Paulsgrove or Bailey is economies of scale, which is typically the strategy behind a pure horizontal merger. With a vertical merger, a firm moves up or down the supply chain (i.e., acquiring a firm that makes the equipment to make pacemakers, or buying a hospital to distribute the products). With a conglomerate merger, the businesses operate in separate industries.

Question #49 of 102

Question ID: 462869

The difference between a spin-off and a split-off is that in a spin-off:

✓ A) **the parent's existing shareholders receive shares in the new firm on a pro-rata basis, whereas they must surrender their shares in the parent to obtain shares of the new firm in a split-off.**

✗ B) shares in the new firm are distributed on a pro-rata basis to existing shareholders, but are sold via a public offering in a split-off.

✗ **C)** the parent's existing shareholders must surrender their shares in the parent to obtain shares of the new firm, whereas they receive shares in the new firm on a pro-rata basis in a split-off.

Explanation

In a spin-off, shares of the new firm are distributed to the parent's existing shareholders on a pro-rata basis. In a split-off, the parent's existing shareholders must surrender their shares in the parent to obtain shares in the new firm.

Question #50 of 102

Question ID: 462796

In general, in order for earnings per share bootstrapping to occur, which of the following is *most* accurate?

✗ **A)** **The P/E ratio of the target must be greater than that for the acquirer.**

✓ **B)** The price-to-earnings (P/E) ratio of the acquirer must be greater than that for the target.

✗ **C)** The net income of the target must be greater than that for the acquirer.

Explanation

In order for earnings per share bootstrapping to occur, the P/E ratio of the acquirer must be greater than that for the target.

Questions #51-56 of 102

Clothing Tree is a Milan-based holding company. The holding company comprises individual firms with unique brands that produce and sell products ranging from infant and children's clothing, to fashion wear, to work uniforms, to undergarments. The firm's founder and chairman, Romano Nocci, says that "since we assume that people will continue to wear clothes, we continue to believe that this is a good business for the long haul."

However, in spite of his overall belief in the soundness of the clothing market, he realizes that tastes and fashions change, and believes that the firm should constantly be on the lookout for suitable candidates to add to the Clothing Tree empire. He also believes that it may make sense to restructure the firm by creating a new holding company, Family Tree, to own the Clothing Tree plus two new divisions-Food Tree and Drug Tree.

The Food Tree would be a holding company formed to acquire companies in all phases of the food business. The Drug Tree would be a holding company formed to acquire companies in all phases of the non-prescription pharmaceuticals market. Both of these product lines are necessary goods, so Nocci believes that they would fit well with the firm's existing clothing businesses.

To help implement this acquisition strategy, Nocci has hired Zurich Investment Advisers. Armando Palocci, CFA has been assigned to be the lead advisor in this effort. When Palocci and his team met with Nocci and other key Tree managers, they discussed a wide-ranging set of subjects relating to the nascent acquisition plans. These discussions are summarized in the paragraphs below.

Palocci asks whether additions to the Tree empire will continue to maintain their identities. For example, if Food Tree were to purchase Parma Foods, would the company be operated as a subsidiary and maintain its identity, or would it be combined with other acquisitions and rebranded as Food Tree? Nocci indicates that this would likely depend upon the value of maintaining the brand versus the efficiencies that could be gained from combining acquisitions.

Does the Tree want to avoid firms that have takeover defenses in place? If so, which types of defenses? Nocci responds that he "would prefer to avoid firms that have pre-offer defenses, such as poison pills and pac-man defenses in place because these make the cost of an acquisition prohibitive. However, if a firm has shown a willingness to pay greenmail in the past, he would not be averse to testing the management again on this count."

Some of the acquisition targets will likely have business interests in the U.S. and Canada, as well as Europe. Palocci describes to Nocci how industry concentration is measured in the U.S., and what might cause an acquisition to be challenged on antitrust grounds. Nocci indicates that whether or not it makes sense to run the risk of an antitrust challenge will depend, in part, on the potential gains from the merger. Thus, they must be evaluated on a case by case basis.

Palocci and Nocci conclude their discussions with a review of acquisition target valuation methods, the evidence concerning the distribution of merger benefits, and strategies that the firm might employ if it were to purchase a firm with several divisions, some of which it does not wish to keep.

Question #51 of 102

Question ID: 462844

If Food Tree is successful in purchasing a food company for which it maintains the firm's existing identity and brands, the first such purchase would be classified as a:

✗ **A)** **subsidiary, horizontal merger.**

✓ **B)** subsidiary, conglomerate merger.

✗ **C)** statutory, conglomerate merger.

Explanation

The first food company, being in an entirely different business from clothing, would have to be considered a conglomerate merger. The fact that the firm intends to maintain the target's identity after it is acquired indicates that it would be considered a subsidiary merger. (Study Session 9, LOS 29.a)

Question #52 of 102

Question ID: 462845

With regard to Nocci's description of the types of takeover defenses he would prefer to avoid, he is:

✗ **A)** **incorrect with respect to the poison pill defense, and incorrect with respect to the pac-man defense.**

✗ **B)** correct with respect to the poison pill defense, and correct with respect to the pac-man defense.

✓ **C)** correct with respect to the poison pill defense, but incorrect with respect to the pac-man defense.

Explanation

Nocci is correct with respect to the poison pill defense. It is a pre-offer defense that can make an acquisition prohibitively expensive. The pac-man defense is a post-offer defense. It involves the acquisition target turning the table and attempting to acquire the firm that is making the offer. (Study Session 9, LOS 29.f)

Question #53 of 102

Question ID: 462846

With respect to antitrust challenges in the United States, Palocci should have told Nocci that the decision to challenge is based upon a:

✓ **A) quantitative measure of industry concentration, but that the issue is not clear-cut.**

✗ **B)** qualitative measure of industry concentration, but that the issue is not clear-cut.

✗ **C)** quantitative measure of industry concentration, and that the issue is clear-cut once the change in the measure is known.

Explanation

Palocci should have told him that the decision to challenge is based upon a quantitative measure of industry concentration, but that the issue is not necessarily clear-cut. (Study Session 9, LOS 29.g)

Question #54 of 102

Question ID: 462847

Food Tree is likely to have to evaluate potential acquisition targets that are temporarily experiencing financial distress or earnings problems that can be solved with an application of the Tree's financial strength and management expertise. That said, the food industry, by and large, consists of firms that have relatively predictable revenue and cost patterns, and the level of investment risk is well-understood. All else being equal this set of circumstances would seem to argue for which of the following valuation approaches?

✓ **A) Discounted cash flow.**

✗ **B)** Comparable company.

✗ **C)** Comparable transaction.

Explanation

If a firm is in financial distress or experiencing earnings problems, this will make it difficult to apply the comparable company or comparable transaction approaches. However, if the firm can be restored to health and future cash flows and risks are fairly predictable, this implies that discounted cash flow valuation may provide the best results. (Study Session 9, LOS 29.i)

Question #55 of 102

Question ID: 462848

Suppose that Drug Tree has identified three comparable companies relative to a target under evaluation. The valuation metric is price to sales (P/S). The three comparable companies have P/S ratios of 2.17, 1.98, and 2.09. The target has sales of 600m. What value of the P/S should be applied to the target, and what is the estimated value?

	P/S	Estimated Value
✗ **A)**	**2.17**	**1302m**
✓ **B)**	2.08	1248m
✗ **C)**	1.98	1188m

Explanation

The appropriate value to apply to the target is the average, or P/S = 2.08. If sales = 600m then solving for P = 2.08 × 600m yields an estimated target value of 1248m. (Study Session 9, LOS 29.j)

Question #56 of 102

Question ID: 462849

Palocci advises that if the Food Tree purchases a firm that includes a division that does not fit the Tree's strategic plan, the firm can sell the division via divestiture, equity carve-out, spin-off, or split-off. However, he tells Nocci that only the divestiture will provide Food Tree with cash after completion, because the others all involve the distribution of stock in the division. Palocci's advice is:

✗ **A)** **incorrect with respect to the alternatives, and incorrect with respect to the provision of cash.**

✗ **B)** correct with respect to the alternatives, and correct with respect to the provision of cash.

✓ **C)** correct with respect to the alternatives, but incorrect with respect to the provision of cash.

Explanation

Palocci's list of methods is correct for a going concern (liquidation is also an option if the firm is in financial distress, which is assumed not to be the case here). However, he is incorrect with respect to the provision of cash. An equity carve-out will also generate cash, via the public offering of shares in the division. A spin-off or split-off will not generate cash for Food Tree. (Study Session 9, LOS 29.n)

Question #57 of 102

Question ID: 462866

Which of the following characteristics is *least likely* to be indicative of a merger and acquisition transaction that creates value for the acquirer?

✗ **A)** **The initial market reaction is favorable.**

✗ **B)** The buyer is strong.

✓ **C)** The number of bidders is high.

Explanation

An M&A transaction where the number of bidders is low (not high) points to an M&A transaction that creates value. Past empirical results suggest that M&A deals create value when 1) the buyer is strong, 2) transaction premiums are low, 3) the number of bidders is low, and 4) the initial market reaction is favorable.

Question #58 of 102

Question ID: 462834

Felix Hernandez is evaluating a prospective merger between two firms of relatively equal size. The acquirer is planning to borrow the entire purchase price and pay for the merger in cash. Which method of estimating the target's intrinsic value and potential merger synergies is likely to be *most* useful?

✗ **A)** **Comparable company analysis because the values are market-based.**

✓ **B)** Discounted cash flow analysis because it will allow him to incorporate changes in the capital structure and cost of capital that are likely to result from the way the acquirer intends to raise the funds to pay for the target.

✗ **C)** Comparable company analyses because the assumption that similar assets should have similar values is fundamentally sound.

Explanation

Because the firms are of relatively equal size, and because the acquirer is planning to borrow the entire purchase price, it appears probable that the outcome will be a large change in capital structure. Comparable company analysis assumes that the capital structure remains fairly constant. Discounted cash flow analysis allows the analyst to incorporate changes in cash flows and the combined firm's WACC that are likely to result from the change in capital structure.

Question #59 of 102

Question ID: 462832

Gambit Enterprises is being evaluated as an acquisition target. An analyst estimates the firm's free cash flows as $10m, $20m, $30m, $40m, and $50m over the upcoming 5 years. At the end of year 5, you estimate that the firm's value will be $1000m. If the weighted average cost of capital (WACC) is 8%, what is your estimated value of the firm today?

- ✓ **A) $794m.**
- ✗ **B)** $683m.
- ✗ **C)** $881m.

Explanation

Value = $V = \frac{10}{1.08} + \frac{20}{(1.08)^2} + \frac{30}{(1.08)^3} + \frac{40}{(1.08)^4} + \frac{1050}{(1.08)^5} = \$794\text{m}$

Question #60 of 102

Question ID: 462805

Conglomerate mergers are *least likely* for companies in which stages of the industry lifecycle?

- ✓ **A) Mature Growth, Stabilization.**
- ✗ **B)** Pioneer/Development, Rapid Growth.
- ✗ **C)** Stabilization, Decline.

Explanation

Conglomerate mergers are least likely for firms in the mature growth and stabilization stages of the industry lifecycle. In these stages, industry growth is slowing, and they are more likely to be seeking horizontal mergers to enhance economies of scale.

Questions #61-66 of 102

World Beaters, a maker of electric mixers and other kitchen appliances, is considering a hostile takeover of Gadgets N' More, a catalog retailer specializing in products for the kitchen. World Beaters is planning to use its own stock for the acquisition.

Lars Clausen, deputy chief financial officer for World Beaters, is preparing a report on the potential merger for senior management.

After a review of financial literature on mergers and extensive interviews with managers of both World Beaters and Gadgets N' More, Clausen submits a report recommending against the merger. The reasons for his disapproval are listed below:

> - Gadgets N' More's stock price reflects a higher growth rate than World Beater's, and aquisition will lower per-share

> profits.
> - Shareholders will not benefit from World Beater's new lower financing rates post acquisition.
> - Because the merger must be an acquisition of assets, World Beaters will need shareholder approval from Gadgets N' More.

Regardless of the recommendations to the board, Clausen sets out to compute a fair price for the acquisition of Gadgets N' More. He analyzes the recent acquisition of Tera Inc by King Inc at a price of $34 per share of Tera Inc. Prior to media reports about the acquisition, Tera's stock was trading at $28 per share. However, when the pending acquisition was leaked in the popular media, Tera's stock price jumped to $38.

Clausen then evaluates Gadgets N' More's corporate governance. He notes that the company's on corporate governance practices include the following statements:

Statement 1: Management assesses the board's performance annually.
Statement 2: At least 75% of the audit committee of the board should be independent.

Gadgets N' More has 78 million shares outstanding while World Beaters has 223 million shares outstanding. Gadgets N' Mores stock was trading at a price of $20 per share pre-announcement while World Beater's stock was trading at $43 per share. Clausen estimates the total present value of cost savings due to the merger to be $200 million.

Question #61 of 102

Question ID: 462854

Which of Clausen's arguments against the merger is *least* valid?

✓ **A)** **Because the merger must be an acquisition of assets, we will need approval from Gadgets N' More shareholders.**

✗ **B)** Shareholders will not benefit from World Beaters' new lower financing rates.

✗ **C)** Gadgets N' More has a higher growth rate than World Beater's, and a purchase will lower per-share profits.

Explanation

In an acquisition of assets, the acquirer buys assets directly from the company, skirting shareholders. As such, the claim that World Beaters will need shareholder approval is false, and the argument is invalid. When a high-growth firm purchases a low-growth firm, per-share profits are temporarily boosted, thus lowering future growth prospects on a per-share basis. Since Gadgets 'N More has a higher growth rate than World Beaters, the effect will be just the opposite, depressing EPS in the near term. While the acquisition could boost the growth rate going forward because of the depression of current earnings and the integration of a faster-growth business, this could indeed be used as an argument against a merger, as in some cases, any one-time decline in EPS is unacceptable. As such, this argument is somewhat valid. Lower financing rates benefit the company, but usually not shareholders, because the company's price likely reflects the fact that shareholders of both companies end up guaranteeing each other's debt.

(LOS 29.b,c, e)

Question #62 of 102

Question ID: 462855

World Beaters's proposed purchase of Gadgets N' More is *best described* as a:

✗ **A)** **horizontal merger.**

✗ **B)** conglomerate merger.

✓ **C)** vertical merger.

Explanation

In a vertical merger, the acquiring company moves up or down the supply chain. In this case, World Beaters wants to buy a retailer that sells its products, moving up the supply chain toward consumers.

(LOS 29.a)

Question #63 of 102

Question ID: 462856

The acquisition premium paid under the Tera acquisition is *closest* to:

✓ **A)** **21%**

✗ **B)** -11%

✗ **C)** 58%

Explanation

Takeover premium = Acquisition price/pre-announcement price - 1 = 34/28 - 1 = 21.4%

(LOS 29.k)

Question #64 of 102

Question ID: 462857

Statement 1 of Gadgets N' More's corporate governance practices is:

✓ **A)** **unlikely to be an effective corporate governance practice due to the party responsible for assessment.**

✗ **B)** likely to be an effective corporate governance practice.

✗ **C)** unlikely to be an effective corporate governance practice due to the frequency of assessment.

Explanation

Effective corporate governance practices calls for board to perform self-assessment (rather than management assessing the board).

(LOS 28.e)

Question #65 of 102

Question ID: 462858

Statement 2 of Gadgets N' More's corporate governance practices is:

✗ **A)** **Unlikely to be an effective corporate governance practice because a lower percentage of board members should be independent.**

✓ **B)** Unlikely to be an effective corporate governance practice because a higher percentage of board members should be independent.

✗ **C)** Likely to be an effective corporate governance practice.

Explanation

Effective corporate governance practices calls for 100% of the members of the audit committee of the board to be independent.

(LOS 28.e)

Question #66 of 102

Question ID: 462859

If World Beaters's board accepts a 1:2 stock exchange offer (1 share of World Beaters per 2 shares of Gadgets N' More), the takeover premium paid to shareholders of Gadgets N' More is *closest* to:

- ✗ **A) 7.5%**
- ✓ **B)** 8.3%
- ✗ **C)** 11%

Explanation

TP = P_T - V_T where P_T = N x P_{AT} for a stock acquisition.
P_{AT} = $_{VAT}$ / # of shares
V_{AT} = (223 million x $43) + (78 million x $20) + $200 million = $11,349 million.
# of shares post-merger = 223 million + 78/2 million = 262 million
P_{AT} = $11,349 / 262 = $43.32
P_T = 0.5 x 43.32 = 21.66
TP = 21.66 - 20 = $1.66 per share or 1.66/20 = 8.3%

(LOS 29.k)

Question #67 of 102

Question ID: 462791

When bootstrapping, the acquiring firm purchases:

- ✗ **A) high growth firms with high price-to-earnings (P/E) ratios.**
- ✓ **B)** slow growth firms with low price-to-earnings (P/E) ratios.
- ✗ **C)** high growth firms with low price-to-earnings (P/E) ratios.

Explanation

Bootstrapping involves a high growth, high P/E ratio firm purchasing slow growth firms with low P/E ratios. The low P/E implies that the acquiring firm can purchase the firm "cheap" since its stock exhibits a higher price for a given level of earnings. The end result is that the earnings of the two firms are added together, while the exchange of high P/E company's shares are made at a less than 1 to 1 ratio for the low P/E company shares. Thus, earnings per share will increase due to the lower total number of shares outstanding.

Question #68 of 102

Question ID: 462795

When bootstrapping, the acquiring firm:

- ✗ **A) increases current and historical earnings per share (EPS) by the amount of the synergy created between the companies.**
- ✓ **B)** increases current earnings per share (EPS) without creating any economic gains.

✗ **C)** decreases current earnings per share (EPS) because of the increases in the total number of shares outstanding.

Explanation

The technique of bootstrapping increases EPS for the acquiring firm without creating any economic gains. Any synergy between the companies will only increase future earnings and is not relevant to bootstrapping.

Question #69 of 102

Question ID: 462862

Which of the following statements regarding merger synergies are *least* accurate?

✓ **A) In a stock offer, all of the risks and potential rewards shift to the target shareholders.**

✗ **B)** In a stock offer, if estimates regarding the value of the synergies are too high, the target shareholders will bear some of the downside.

✗ **C)** The more confident the acquirer is that synergies will be realized, the more likely they will make a cash offer.

Explanation

In a stock offer, some of the risks and potential rewards shift to the target shareholders. Both remaining statements are correct as presented.

Question #70 of 102

Question ID: 462770

Burger World is interested in obtaining a controlling interest in Snappy Auto Repair. This potential merger is best described as a:

✓ **A) conglomerate.**

✗ **B)** horizontal merger.

✗ **C)** vertical merger.

Explanation

Combining firms in separate industries represents a conglomerate merger.

Question #71 of 102

Question ID: 462864

Which of the following statements regarding the distribution of the benefits from a merger are *least* accurate?

✓ **A) Short-term performance around the date of a merger suggests that target management suffers from reference dependence in attempting to extract value for shareholders.**

✗ **B)** Long-term performance following a merger transaction suggests that the acquiring firm is unable to capture the synergies expected prior to the merger.

✗ **C)** The winners curse implies that in a contested takeover, on average, the winning bidder overpays for the target.

Explanation

Short-term performance around the date of a merger suggests that, on average, target shareholders benefit handsomely from the completion of a merger transaction. In fact, they appear to extract all of the benefits of the merger. Reference dependence is a behavioral finance term that does not appear to be applicable to target firm management in the case of mergers.

Question #72 of 102

Question ID: 462836

An analyst has identified three companies that they believe are comparable to a firm under evaluation as a takeover candidate. The relative value measures that they have selected are price-to-earnings (P/E) and price-to-sales (P/S), and the average values of these ratios are 13.2 and 1.3. The target firm has earnings per share of $3.75, and sales per share of $36.08. If the estimated takeover premium is 25%, what is the estimated takeover price per share?

✗ **A) $58.63.**

✓ **B)** $60.25.

✗ **C)** $61.88.

Explanation

The estimated value based upon P/E is $49.50 = (3.75 × 13.2).
The estimated value based upon P/S is $46.90 = (36.08 × 1.3).
The average of these two values is $48.20.
The estimated takeover price is $48.20 × 1.25 = $60.25.

Question #73 of 102

Question ID: 462863

Which of the following statements regarding a cash offer are *least* accurate?

✗ **A) If the synergies are less than expected, the acquirer will bear the cost.**

✗ **B)** The target's payoff is fixed, regardless of the synergies realized.

✓ **C)** The target assumes some of the risk regarding the value of the synergies.

Explanation

The target's payoff is fixed, and the acquirer assumes the risk and the reward regarding the value of the synergies.

Question #74 of 102

Question ID: 462792

Which of the following statements regarding bootstrapping and its effect on earnings per share (EPS) is CORRECT? Bootstrapping:

✓ **A) increases current EPS and decreases future EPS.**

✗ **B)** decreases current EPS and increases future EPS.

✗ **C)** increases current EPS and increases future EPS.

Explanation

Bootstrapping increases current EPS at the expense of lower growth prospects and lower future EPS.

Question #75 of 102

Question ID: 462816

There are 12 firms in an industry, 10 of them have a market share of 7% each, and 2 of them have a market share of 15% each. If 2 of the 7% market share firms agree to merge, calculate the pre- and post-merger Herfindahl-Hirschman Index, and evaluate the likelihood that the merger will be challenged on antitrust grounds.

✓ **A) Pre-merger HHI = 940; Post-merger HHI = 1038; Unlikely.**

✗ **B)** Pre-merger HHI = 940; Post-merger HHI = 1038; Possible.

✗ **C)** Pre-merger HHI = 833; Post-merger HHI = 972; Unlikely.

Explanation

The pre-merger HHI = 940 = ((7 × 7 × 10) + (15 × 15 × 2)), the post-merger HHI = 1038 = ((7 × 7 × 8) + (14 × 14 × 1) + (15 × 15 × 2)). Since the change is less than 100, a challenge is unlikely.

Question #76 of 102

Question ID: 462810

What form of acquisition is *most likely* to be associated with a hostile takeover, and which defense is *most likely* to be employed by the target's management to fend off the unwanted offer?

✓ **A) Stock purchase and greenmail.**

✗ **B)** Asset purchase and greenmail.

✗ **C)** Stock purchase and poison pill.

Explanation

A stock purchase is more likely when the target is hostile to the proposed merger because an asset purchase would ordinarily involve negotiations between two mutually agreeable parties. A poison pill is a pre-offer defense. If one were in place, it would be employed, but if it existed it is far less likely that a hostile merger would ever be proposed. Hence, greenmail is a more likely defense mechanism because it is a post-offer takeover defense.

Question #77 of 102

Question ID: 462769

Which type of merger is *most likely* when the motivation for merging is to bootstrap earnings per share (EPS), and what does this imply about the lifecycle stage of the acquirer and the target?

✓ **A) Conglomerate and different stages.**

✗ **B)** Conglomerate and same stage.

✗ **C)** Horizontal and different stages.

Explanation

In order for EPS bootstrapping to occur, the target must have a lower price-to-earnings (P/E) ratio than the acquirer. Since firms in the same industry are more likely to have similar P/Es, this makes a horizontal merger less likely. The differential in P/Es implies a differing level of expected growth. All else being equal, this suggests that the firms will be in different lifecycle stages.

Question #78 of 102

Question ID: 462852

Big Steel is considering making a bid for Small Steel. The following data applies to the analysis:

	Big Steel	Small Steel
Pre-merger stock price	$75	$100
Number of shares outstanding	500m	40m
Pre-merger market value	$37,500m	$4,000m
Estimated synergies	$600m	

If Big Steel buys Small Steel for $110 per share in cash, what are the gains to Big Steel and Small Steel, respectively?

	Big Steel	Small Steel
✗ **A)**	**$400m**	**$200m**
✗ **B)**	$500m	$100m
✓ **C)**	$200m	$400m

Explanation

Gains to Small Steel = takeover premium = $4,400 - $4,000 = $400m.
Gains to Big Steel = synergies - takeover premium = $600 - $400 = $200.

Question #79 of 102

Question ID: 462840

An analyst has identified three companies (AAA, BBB, and CCC) that have recently been taken over and are comparable to a firm under evaluation as a takeover candidate. The relative value measures they have selected are the price-to-earnings (P/E) and price-to-sales (P/S). The takeover price, earnings per share, and sales per share, for each company, respectively, are as follows:

	Takeover Price	**EPS**	**Sales per Share**
AAA	65	4.80	48.00
BBB	149	10.40	118.75
CCC	26	1.80	19.50

What values for these ratios should be applied to the target firm?

✓ **A) P/E = 14.1x, P/S = 1.31x.**

✗ **B)** P/E = 14.3x, P/S = 1.33x.

✗ **C)** P/E = 13.5x, P/S = 1.25x.

Explanation

	Takeover Price	EPS	Sales per Share	P/E	P/S
AAA	65	4.80	48.00	13.5	1.35
BBB	149	10.40	118.75	14.3	1.25
CCC	26	1.80	19.50	14.4	1.33

$$P/E = \frac{13.5 + 14.3 + 14.4}{3} = 14.1x$$

$$P/S = \frac{1.35 + 1.25 + 1.33}{3} = 1.31x$$

Question #80 of 102

Question ID: 462774

Burger World has purchased a large farming company so it can control the quality of the french fries it serves in its restaurants. This merger is best described as a:

✗ **A) horizontal merger.**

✓ **B)** vertical merger.

✗ **C)** diversifying merger.

Explanation

In a vertical merger, the acquiring company seeks to move up or down the product supply chain. The purchase of the farming company is a move backward in the supply chain towards the raw material inputs.

Question #81 of 102

Question ID: 462815

Which of the following takeover defenses are considered pre-offer defenses?

✗ **A) Poison pills, staggered boards and litigation.**

✓ **B)** Fair price amendments, poison puts and staggered boards.

✗ **C)** Liability restructuring, poison pills and supermajority voting provisions.

Explanation

Pre-offer defense mechanisms to avoid a hostile takeover include poison pills, poison puts, reincorporating in a state with restrictive takeover laws, staggered board elections, restricted voting rights, supermajority voting, fair price amendments, and golden parachutes.

Questions #82-87 of 102

Riley Industries is a manufacturer of after-market automobile parts that are distributed and sold throughout the United States. The company possesses significant market share, with last year's sales exceeding $450 million. Gross sales of Riley Industries, plus two other comparable-sized competitors, represent roughly 60% of parts sold to the major auto parts retailers in the U.S. last year. Of the remaining 40% of sales, market share is highly fragmented, with no single supplier exceeding 5% of the market's overall market sales. Riley Industries' management has proposed a merger with Durable Parts, a small manufacturer with sales of $50 million per year. The merger with Durable Parts would give Riley Industries an additional manufacturing facility in a central region of the country where Riley Industries does not currently have production operations. Previously, Riley Industries' management had considered the possibility of constructing a new facility in that area, and Durable Part's relatively new facility can provide the additional capacity that Riley Industries is seeking in order to meet increasing demand.

The proposed merger is structured as a stock purchase, in which the shareholders of Durable Parts receive shares of Riley Industries' common stock. The proposed exchange ratio is 1:5, meaning that for every 5 Durable Parts shares owned, shareholders will receive one share of Riley Industries.

	Riley Industries	*Durable Parts*	*Riley — Post Merger*
Stock Price	$50.00	$10.00	$50.00
EPS	$3.50	$2.25	
P/E Ratio	14.29	4.44	
Total shares o/s	9,000,000	3,000,000	

Neither the management nor the shareholders of Durable Parts had anticipated being the target of a merger transaction. Several members of the board have expressed their desire to remain an independent entity, and have proposed seeking a friendly third party that would be willing to purchase a minority stake in the company without buying controlling interest. This would block Riley Industries from gaining enough shareholder approval to purchase the entire operation. The board acknowledges that there is some additional risk involved in the pursuit of this strategy, but is not aware of any other viable options that would allow Durable Parts to remain an independent company.

Additionally, the same members of Durable Part's board of directors have instructed the company's accountants to estimate the Herfindahl-Hirschman Index (HHI) for the industry, both pre- and post-merger. They estimate the pre-merger HHI is 975, while the post-merger HHI is 990. They believe that the increase in post-merger HHI indicates that Riley Industries should not continue to pursue the merger because of a likely antitrust challenge.

Question #82 of 102

Question ID: 462798

The impetus behind the merger of Riley Industries with a Durable Parts, a smaller competitor, is to provide Riley with the means to increase its own production capacity. This type of merger is commonly called a:

- ✗ **A) consolidation.**
- ✓ **B)** horizontal merger.
- ✗ **C)** synergistic merger.

Explanation

In a horizontal merger, both entities operate in the same or similar industries, and the operations of the combined company would be similar to the two, pre-merger companies. (Study Session 9, LOS 29.a)

Question #83 of 102

Question ID: 472532

The strategy whereby a high P/E firm acquires a low P/E firm in exchange for stock is commonly called:

- ✓ **A) bootstrapping.**
- ✗ **B)** Backward integration.
- ✗ **C)** vertical merger.

Explanation

Bootstrapping combines the earnings from two companies after a merger so that the result of the merger is an increase in earnings per share of the acquirer, even though no real economic gains have been achieved. (Study Session 9, LOS 29.c)

Question #84 of 102

Question ID: 462800

Given the above information, the post-merger EPS of Riley Industries is *closest* to:

- ✗ **A) $3.19.**
- ✓ **B)** $3.98.
- ✗ **C)** $3.04.

Explanation

Using the 1:5 exchange ratio, Riley will issue 600,000 shares (3,000,000 / 5). The 1:5 conversion ratio is intuitive if you note that Riley's pre-merger stock price is $50 per share and Durable's market cap is $30,000,000 (3,000,000 x $10). Riley issues 600,000 new shares to generate the funds to purchase Durable ($30,000,000 market cap / $50 = 600,000 shares). Thus, the total number of shares outstanding after the merger would be 9,600,000 shares. The total post-merger income ([$3.50 / share × 9,000,000] + [$2.25 / share × 3,000,000]) = $38,250,000. Therefore the post-merger EPS is $38,250,000 / 9,600,000 shares = $3.98.

The result of bootstrapping is the creation of the **appearance** of growth in earnings. The acquiring firm is essentially exchanging high P/E shares for low P/E shares. The combined entity has fewer total shares outstanding than the two separate entities, but the same earnings, resulting in a higher EPS. (Study Session 9, LOS 29.c)

Question #85 of 102

Question ID: 462801

Riley Industries will give the owners of Durable Parts shares of Riley stock in exchange for the outstanding shares of Durable. Which of the following statements regarding a stock purchase is *most* accurate?

- ✓ **A) With a stock purchase, it is the shareholders of the target company that directly receive compensation, not the company itself.**
- ✗ **B)** The shareholders of the target company will not bear any tax consequences associated with the stock purchase; any taxes due are the financial obligation of the acquirer.
- ✗ **C)** Most stock purchases do not involve purchasing the entire company, but rather a portion of the firm or a specific operating division.

Explanation

Since the shareholders are the owners of the target company, they receive the compensation from any acquisition, whether by cash or securities. Typically, a majority of the shareholders must approve the transaction, and sometimes even more than a majority is required. (Study Session 9, LOS 29.e)

Question #86 of 102

Question ID: 462802

The strategy proposed by Durable's management of seeking a friendly third party to purchase a minority stake in its firm in order to block Riley's proposed merger with Durable is *most* commonly referred to as a:

✓ **A)** **white squire defense.**

✗ **B)** white knight defense.

✗ **C)** crown jewel defense.

Explanation

A white squire defense is similar in nature to a white knight defense. A white knight is a friendly third party that will acquire all of the assets of a target company, while a white squire will only buy a minority stake in the target. The white squire will buy enough to thwart a hostile takeover, but not enough to gain control of the target. (Study Session 9, LOS 29.f)

Question #87 of 102

Question ID: 462803

The estimated pre- and post-merger HHI for the industry are 975 and 990 respectively. Which of the following statements regarding these HHI calculations is *most* accurate?

✗ **A)** **Regulators consider a post-merger HHI value greater than 1,800 to be indicative of a "moderately concentrated" industry.**

✗ **B)** Any merger that results in a change in HHI between pre- and post-merger HHI that is greater than 100 is likely to be challenged.

✓ **C)** A post-merger HHI of less than 1,000 is indicative of a competitive industry and an antitrust challenge is unlikely.

Explanation

The HHI is calculated as the sum of the squared market shares for all firms in an industry. A post-merger HHI that is less than 1,000 indicates an industry that is not concentrated, and an antitrust challenge is unlikely. (Study Session 9, LOS 29.g)

Question #88 of 102

Question ID: 462812

The difference between a white knight defense and a white squire defense is that the white knight:

✗ **A)** **is a post-offer defense, whereas the white squire is pre-offer.**

✗ **B)** takes a minority interest, whereas a white squire takes over the entire firm.

✓ **C)** takes over the entire firm, whereas a white squire only takes a minority interest.

Explanation

When a firm subject to an unwanted takeover attempt seeks out a friendly third party to purchase the entire firm, this is known as a white knight defense. If the firm seeks out a friendly third party to take a minority interest, this is a white squire defense. Both are post-offer defenses.

Question #89 of 102

Question ID: 462776

Suppose that a manufacturer of steel bridge beams (BridgeCo) acquires its main supplier of the steel (SteelCo) used to make the beams. After the merger is completed, the only surviving entity is BridgeCo. This is best described as a:

- ✗ **A) horizontal merger.**
- ✗ **B)** subsidiary merger.
- ✓ **C)** vertical merger.

Explanation

This is best described as a vertical merger, since BridgeCo is purchasing a company from which it gets production inputs. It could also be described as a statutory merger, since only the acquiring firm is in existence following the combination.

Question #90 of 102

Question ID: 462807

Firms are *most likely* to seek mergers in order to gain access to capital during which industry lifecycle stages?

- ✗ **A) Pioneer/Development and Decline.**
- ✓ **B)** Pioneer/Development and Rapid Growth.
- ✗ **C)** Rapid Growth and Mature Growth.

Explanation

The industry lifestyle stages during which firms often merge to gain access to additional capital are the pioneer/development and rapid growth stages.

Question #91 of 102

Question ID: 462808

When a merger occurs, the two main forms for the acquisition are:

- ✓ **A) stock purchase or asset purchase.**
- ✗ **B)** asset purchase or liability assumption.
- ✗ **C)** asset purchase or subsidiary carve-out.

Explanation

The two main forms of acquisition are stock purchase-the acquirer purchases all of the target's stock-or asset purchase-the acquirer agrees to purchase all of the target's assets.

Questions #92-97 of 102

Toulouse Tempered Steel Industries (TTS) is weighing its strategic options following a wave of mergers in the industry across Europe and worldwide. Pascal LaPage, managing director of TTS is wondering whether it makes sense for the firm to position itself as a standalone entity, or if the firm should be pursuing a merger/acquisition of another firm that would provide a good strategic fit. Lyon Bank has been the firm's primary lender for many years, and Alaine Clamon, CFA, from Lyon's corporate finance department is due to meet with LaPage and other members of the firm's finance group to discuss some strategic options.

Clamon begins his presentation with the underlying rationale for considering a merger or acquisition as a strategic alternative. Some justifications for mergers cited by Clamon are the pursuit of economies of scale, the elimination of operating inefficiencies, and diversification of the firm's assets. LaPage asks his staff to keep these justifications in mind as they seek suitable candidates for evaluation.

Clamon states that a pure asset purchase does not require approval from target shareholders for relatively small purchases but the acquirer pays capital gains tax on it. He cautions the board of TTS about possible antitrust actions. Specifically Clamon warns against getting into a situation where the Herfindahl-Hirschman Index exceeds 1250, wherein antitrust action would be virtually certain.

A member of staff asks Clamon about types of takeover defenses that might by employed by either Aragon or Brittany. Clamon replies that these fall broadly into two categories, pre-offer and post-offer defenses. As examples of pre-offer defenses he describes staggered boards and supermajority voting provisions. As an example of post-offer defenses he describes the crown jewel defense. Clamon gives an example of a strategy covered in the news lately. The strategy involved Atlas Software's CEO recruiting the CEO of Paragon Textile, his friend, whereby Paragon bought just enough Atlas shares to block a hostile merger. Clamon notes that, obviously, TTS must take care to account for the ramifications of the presence of any takeover defenses.

Question #92 of 102

Question ID: 462785

Which of the following is *least likely* to represent a traditional type of merger between two firms?

✗ **A)** **Horizontal.**

✓ **B)** Syndicate.

✗ **C)** Conglomerate.

Explanation

The traditional types of mergers are horizontal, vertical, and conglomerate. Syndicate is not a term that is traditionally used to describe mergers.

(LOS 29.a)

Question #93 of 102

Question ID: 462786

With regard to his list of sensible motives for undertaking a merger, Clamon is:

✓ **A)** **correct with regard to operating inefficiencies, but incorrect with regard to diversification.**

✗ **B)** correct with regard to operating inefficiencies, and correct with regard to diversification.

✗ **C)** incorrect with regard to operating inefficiencies, but correct with regard to diversification.

Explanation

Pursuing a merger where the underlying rationale is to eliminate operating inefficiencies is generally considered sensible. A merger in pursuit of diversification is generally not seen as sensible, since it is ordinarily much more cost-effective for shareholders to diversify on their own.

(LOS 29.b)

Question #94 of 102

Question ID: 462787

With respect to the takeover defenses he described, Clamon is:

✓ **A)** **correct with regard to the pre-offer defenses listed, and correct with regard to the post-offer defense listed.**

✗ **B)** correct with regard to the pre-offer defenses listed, but incorrect with regard to the post-offer defense listed.

✗ **C)** incorrect with regard to the pre-offer defenses listed, but correct with regard to the post-offer defense listed.

Explanation

In both cases, Clamon has correctly provided examples of pre-offer and post-offer takeover defenses.

(LOS 29.f)

Question #95 of 102

Question ID: 462788

With regard to the strategy employed by the CEO of Atlas, it is most accurately classified as:

✗ **A)** **White knight defense, a post-offer takeover defense strategy.**

✗ **B)** Poison put, a pre-offer takeover defense strategy.

✓ **C)** White squire defense, a post-offer takeover defense strategy.

Explanation

A blocking purchase without gaining outright control is known as the White squire defense. It is a post-offer takeover defense strategy.

(LOS 29.f)

Question #96 of 102

Question ID: 462789

With respect to pure asset purchases, Clamon is:

✗ **A)** **correct with regard to approval from shareholders and correct about who pays capital gains tax.**

✓ **B)** correct with regard to approval from shareholders but incorrect about who pays capital gains tax.

✗ **C)** incorrect with regard to approval from shareholders and incorrect about who pays capital gains tax.

Explanation

For relatively smaller asset purchases, no target firm shareholder approval is necessary. Capital gains taxes (if applicable) would be paid by the target firm (and not the acquiring form).

(LOS 29.e)

Question #97 of 102

Question ID: 462790

Which of the following is *least likely* to represent a valid reason for divestiture?

- ✓ **A)** **Synergy.**
- ✗ **B)** Lack of profitability.
- ✗ **C)** Infusion of cash.

Explanation

Reverse Synergy, lack of profitability and infusions of cash are valid reasons for divestiture. Synergy is valid rationale for acquisition and not for divestiture.

(LOS 29.o)

Question #98 of 102

Question ID: 462771

Which of the following represents a vertical merger?

- ✓ **A)** **An automobile manufacturer purchasing a tire manufacturer.**
- ✗ **B)** A hamburger chain purchasing a pizza chain.
- ✗ **C)** An automobile manufacturer divesting its tire manufacturing division.

Explanation

In a vertical merger, the acquiring company seeks to move up or down the product supply chain. In purchasing a tire manufacturer, the automobile manufacturer is acquiring one of its inputs to production.

Question #99 of 102

Question ID: 462839

Fuel Cell Enterprises is in a new and rapidly-evolving industry, and is being evaluated as an acquisition candidate by Auto Giant, Inc. There are about 10 firms that broadly resemble Fuel Cell, but none of its competitors have been taken over up to this point. Because of the nature of the firm's technology, the level of risk is difficult to estimate and may change rapidly as the technology matures. Which type of analysis is likely to be *most* appropriate in the valuation of Fuel Cell?

- ✗ **A)** **Comparable transaction analysis.**
- ✗ **B)** Discounted cash flow analysis.
- ✓ **C)** Comparable company analysis.

Explanation

The fact that no mergers of similar companies have occurred effectively rules out comparable transaction analysis. The difficulty in estimating the firm risk suggests that discounted cash flow analysis is fraught-small changes in the discount rate can lead to large changes in estimated firm value. Since there is a sufficiently large sample of firms similar to Fuel Cell, this suggests that comparable company analysis is likely to be most appropriate.

Question #100 of 102

Question ID: 462870

Which of the following statements regarding equity carve-outs is *least* accurate?

- ✗ **A) The management team and operations are separate from the parent company.**
- ✗ **B)** Shares of the subsidiary are usually issued in a public offering.
- ✓ **C)** The parent company usually maintains a controlling interest in the new firm.

Explanation

In an equity carve-out, the intent is to establish a new, independent firm. Therefore, the parent company usually does not maintain a controlling interest in the new firm.

Question #101 of 102

Question ID: 462820

There are 6 firms in a given industry, each with an equal market share. Suppose that 2 of the firms decide to merge. Calculate the pre- and post-merger Herfindahl-Hirschman Index, and evaluate the likelihood that the merger will be challenged on antitrust grounds.

- ✗ **A) Pre-merger HHI = 1673; Post-merger HHI = 2503; Virtually certain.**
- ✗ **B)** Pre-merger HHI = 1673; Post-merger HHI = 2224; Possible.
- ✓ **C)** Pre-merger HHI = 1673; Post-merger HHI = 2224; Virtually certain.

Explanation

The pre-merger HHI = 1673 = ((16.7 × 16.7 × 6)), the post-merger HHI = 2224 = ((16.7 × 16.7 × 4) + (33.3 × 33.3 × 1)). Given the 551 point change in the index, an antitrust challenge is virtually certain.

Question #102 of 102

Question ID: 462833

Gambit Enterprises is being evaluated as an acquisition target. For the upcoming year an analyst has estimated the following values: net income = $300m, net interest after tax = $100m, change in deferred taxes = +$25m, depreciation = $200m, change in net working capital = +$30m, CAPEX = $250m. Calculate the firm's estimated free cash flow.

- ✓ **A) $345m.**
- ✗ **B)** $295m.
- ✗ **C)** $405m.

Explanation

Net income + net interest after tax = 300m + 100m = $400m = unlevered net income.
Unlevered net income + change in deferred taxes = 400m + 25m = $425m = NOPLAT.
NOPLAT + depreciation - change in net working capital - CAPEX = 425m + 200m - 30m - 250m = $345m = FCF.