

Questions

Security Analysis – 22.11.2011

1. XYZ Corporation is planning to issue 5 million shares of preferred stock. These shares will pay a perpetual dividend of \$5.00 per share. The current risk-free rate of interest is 3.33% and XYZ is able to issue new bonds at a 10% yield-to-maturity. XYZ is a high-quality company and preferred stocks of similar quality companies are yielding 5%. The per share value of XYZ Corporation's preferred stock is:

 - a. \$5.00
 - b. \$50.00
 - c. \$100.00
 - d. \$150.00

2. Dunlap Corporation is expected to earn \$2.00, \$2.20, and \$2.40 per share in each of the next three years. At the end of the third year, the stock is expected to sell at a current yield of 3%. It is Dunlap's policy of employing a dividend payout ratio of 25%. If an investor demands a 15% return for investing in Dunlap stock, how much should the investor be willing to pay for the shares today?

 - a. \$12.68
 - b. \$14.40
 - c. \$16.67
 - d. \$57.58

3. An analyst is considering acquiring a common stock that will be held for one year. The analyst expects to receive \$1.50 in dividends and \$26.00 from the sale of stock at the end of the year. Using a dividend discount model, the maximum price the analyst should pay for the stock today if the required return is 15% is *closest* to:

 - a. \$23.91
 - b. \$22.61
 - c. \$25.22
 - d. 27.50

4. Suggs Corporation currently pays a \$1.00 dividend. This dividend is expected to grow at a 5% rate for the next two years and the shares are expected to trade at a 2% yield at the end of this two-year period. If an investor requires a 10% return on Suggs' shares, how much should he or she be willing to pay for the stock?

 - a. \$47.32
 - b. \$45.17
 - c. \$55.00
 - d. \$52.50

5. Stevens Inc.'s dividend is assumed to grow at the same rate of 4% forever. The dividend is currently \$2.00 per share. The risk-free rate is currently 2%, the 10-year treasury is 6%, and the investor's required return is 9%. What is the value of Stevens Inc.'s common stock?

- a. \$33.33
- b. \$40.00
- c. 41.60
- d. 52.00

6. Tasha Smith is analyzing the shares of JKL Company. The company currently pays a dividend of \$2.50. She believes the company has a new product that will result in supernormal growth of 20% for two years. Once the market for this product is sutured, she expects that JKL's growth will fall to 3%, which is equal to the level of world economic growth. Ms Smith determines that the required return on JKL should be 12%. What is the value of JKL's shares using a two-stage dividend discount model?

- a. \$33.89
- b. \$38.41
- c. \$33.33
- d. \$40.91

7. The Newton Company is expected to pay a dividend of \$40 per share next year. If Newton's long-term dividend growth rate is 5% per year and its cost of equity is 12%, the price of Newton's common shares using the constant growth dividend discount model is:

- a. \$33.33
- b. 35.00
- c. 57.14
- d. 60.00

8. The Ajax Corporation's current dividend is \$2.00 per share. Its cost of equity capital is 15% and its long-term secular dividend growth rate is 4% per year. Using a constant growth dividend discount model, the value of Ajax's common shares is approximately:

- a. \$13.33
- b. 13.87
- c. \$18.18
- d. \$18.91

9. ALS Corp has just discovered a new process to speed-up microprocessors. They expect their competitors will not be able to duplicate this process until next year. As a result, ALS will be able to grow its earnings and dividends at a 40% rate for the next year. Unfortunately, after one year, this growth is expected to decline to a long-run rate of 3%. The per share value of ALS' common stock if the current year dividend is \$5.00 per share and the required return is 10% is *closest to*:

- a. \$71.43
- b. \$100.00

- c. \$133.64
- d. \$105.00

10. Assuming all other factors remain unchanged, which one of the following would reduce a firm's price/earnings ratio/

- a. The dividend payout ratio increases.
- b. Investors become less risk averse.
- c. The level of inflation is expected to decline.
- d. The yield on risk-free asset increases.

11. Identify the correct statement about price/sales ratios.

- a. A low price/sales ratio indicates an abnormally low debt ratio.
- b. High turnover businesses with low profit margins have high price/sales ratios
- c. Analysts seek out stocks with high price/sales ratios relative to their industry peers to recommend for purchase.
- d. Price/sales ratios are used to avoid the difficulty of normalizing earnings for use in P/E ratios.

12.

Which of the following increases book value per share?

- a. Issuing long-term debt.
- b. retiring long-term debt.
- c. Retiring shares at a market price above book value per share.
- d. Issuing shares at a market price above book value per share.

13. XYZ and RDU are each trading at 20 times trailing (last 12 months) earnings. The respective trailing earnings are \$1.00 and \$2.00 for XYZ and RDU. If XYZ's return on equity is 10% and RDU's return on equity is 20%, what is the price to book value for each company?

	XYZ	RDU
a.	20	20
b.	10	20
c.	10	10
d.	2	4

14. Which of the following situations is it most appropriate to use P/E multiples?

- a. When earnings are highly volatile.
- b. When earnings are negative.
- c. When it is suspected that management may have manipulated EPS.
- d. When earnings are not expected to grow in the future.

15. Which of the following most accurately describes a drawback to using price/book value?

- a. Book value includes estimates for human capital, which are subjective.
- b. Book value measures historic cost, which in some cases can be radically understated relative to market values.

- c. book values per share cannot be calculated for most companies.
- d. Book values can be positive, even when earnings are negative.

16. Newly issued Treasury bills are yielding 5%, the expected rate of inflation is 3%, and the market's cost of common equity capital is estimated to be 12%. Under these circumstances, the real risk-free rate and the market risk premium are approximately:

	Real Risk-Free Rate	Market Risk Premium
a.	2%	10%
b.	7%	2%
c.	5%	7%
d.	2%	7%

17. Company B paid a \$1.00 dividend per share during the past year and is expected to pay out 40% of its earnings as dividends for the foreseeable future. If the firm is expected to generate a 10% return on equity in the future, and if the required return on the stock is 12%, what is the value of the stock?

18. Newly-issued Treasury bills are yielding 6%. For the past several months, the rate of inflation has been averaging 4%. During the next several months, the rate of inflation is expected to average 5%. The real risk-free rate should be approximately:

- a. 1.0%
- b. 1.5%
- c. 2.0%
- d. 6.0%

19. Two companies have substantially different dividend payout ratios. Assuming all other factors are equal, the company with the lower dividend payout ratio is most likely to have:

- a. Lower inventory turnover
- b. Higher inventory turnover
- c. Less rapid growth of earnings
- d. More rapid growth of earnings

20. The C-corporation generates a return on equity of 20% and a 15% return on assets. The company has a policy of retaining 80% of its earnings. C-Corporation's internal growth rate is:

- a. 4%
- b. 12%
- c. 16%
- d. 20%