IMA

CMA-Strategic-Financial-Management

CMA Part 2: Strategic Financial Management Exam

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Question: 1

What is a split-up?

A. Describes the separation of a company into two or more independently run entities
- No subsidiary-parent relationship, because the parent company (A) doesn't exist anymore after the split-up
- May occur to manage different business lines more efficiently (exogenous) or due to government intervention (endogenous: intervention against monopolistic practices)
- Ideally, the combined profits of the separated entities exceed those of the single entity from which they sprang from (the parent company A)

B. When a publicly traded company decides to decrease their outstanding shares by buying them back from the market.
- This involves using cash reserves to purchase shares, leading to a reduction in equity on the balance sheet and a decrease in the number of shares outstanding.
- Companies make cash offers to buy back their outstanding shares. If I buy my own share of someone back than I pay to this person all future dividends of the share (because a share price is a NPV discounted future cashflows)

C. Involves tactically separating a subsidiary as a standalone company trough an IPO
- Parent company retains controlling interest, providing strategic support and resources
- The carve-out is not about selling the business unit outright, but selling a portion of the equity stake of that business
- The parent organization retains controlling interest, keeping the majority equity for itself

D. Firms may voluntarily delist (active decision) when the benefits of public trading diminish: reduce the cost of capital, allow insiders to cash out, facilitate takeover activities and other strategic decisions
- A distressed publicly traded company might be taken private for restructuring by private equity or its management, with the intention of later selling or going public again

Answer: A

Question: 2

All other things held constant, the present value of a given annual annuity decreases as the number of periods per year increases.

A. True
B. False

Answer: A

Question: 3

What are Open-Market Repurchases (OMRs)?

A. It scrutinizes the benefits and costs of leverage
- The primary benefit of debt: tax-benefit of debt
- The primary cost of debt: the cost of financial distress (that you will not be able to repay debt because of the high interest expenses)
- Optimal leverage involves finding a sweet spot that maximizes firm value, considering tax shields and bankruptcy costs
- Tradeoff Theory: Firm value = PV (FCF) + PV (tax-shield) - PV (bankruptcy costs)

B. After the IPO is approved by the relevant regulatory body (SEC in the USA), the effective date and offer price are decided on the day before the IPO.
- Deciding the offer price is important because it is the price at which the issuing company raises capital for itself.
- IPOs are often underpriced to ensure full subscription and compensate investors for risk.

C. A company buys back shares directly from the market via its brokers at the market price without a premium paid
- Its at the market price so cost-effective and no premium is paid: difference with FPTs
- This method is the most commonly used (90% off all repurchases)
- The amount of shares repurchased is relatively small (5% on average) compared to the other methods (15-20%)

D. An option issued to shareholders, allowing them to sell one share at a fixed price (the strike price: set above the current stock price) within a specified period (the time to maturity)
- TPRs are transferable and tradable
- Shareholders with high reservation prices will not be interested in exercising the TPRs and will sell the right
- Shareholders with low reservation prices will be willing to pay extra to buy more TPRs than they originally received

Answer: C

Question: 4

What is the underwriting spread?

A. An action taken by the corporate entity to 'significantly' modify its capital structure or its operations.
B. The purchase of a company by a small group of investors using a high percentage of debt financing
C. When a newly placed stock closes its first day of trading above the set IPO price, it is considered underpriced.
D. Upon selling the shares, the underwriters retain a portion of the proceeds as their fee

Answer: D

Question: 5

Reorganization of assets and ownership via divestitures

A. Asset sales
- Equity carve-outs (ECO)
- Spin-offs
- Split-ups
- Tracking stocks
- Exchange offers
B. Internally: via retained earnings or owner's savings
- Externally: issuing debt or issuing equity
C. An action taken by the corporate entity to 'significantly' modify its capital structure or its operations.
D. Private equity buyout (PE LBO)
- Management buyout (MBO)
- Tender offer

Answer: A

Question: 6

IPO underpricing key reasons

A. Assymetric information underwriter - issuer
- Assymetric information issuer - potential investors
- Assymetric information informed - uninformed investors
- Protection against litigation
- Marketing function
- Broadening ownership base after the IPO
- Facilitating questionable practices
B. Distressed funding (Vulture financing)
- LBO: leveraged buyout (most poplar type)
- Real estate private equity
- Fund of funds
- Venture capital
C. To signal that a stock is undervalued
- To distribute capital to shareholders with a high degree of flexibility in the amount and time
- To take advantages of tax benefits
- To absorbe the increases in the number of shares outstanding due to the exercise of stock options
- To use as a hostile takeover defense
D. Optimizing leverage
- Fine-tuning debt structure
- Fine-tuning equity structure
- Financial reorganization

- Liquidation

Answer: A

Question: 7

Because the maturity risk premium is normally positive, the yield curve is normally upward sloping.

A. True
B. False

Answer: A

Question: 8

Why going private?

A. It scrutinizes the benefits and costs of leverage
- The primary benefit of debt: tax-benefit of debt
- The primary cost of debt: the cost of financial distress (that you will not be able to repay debt because of the high interest expenses)
- Optimal leverage involves finding a sweet spot that maximizes firm value, considering tax shields and bankruptcy costs
- Tradeoff Theory: Firm value = PV (FCF) + PV (tax-shield) - PV (bankruptcy costs)

B. After the IPO is approved by the relevant regulatory body (SEC in the USA), the effective date and offer price are decided on the day before the IPO.
- Deciding the offer price is important because it is the price at which the issuing company raises capital for itself.
- IPOs are often underpriced to ensure full subscription and compensate investors for risk.

C. An operational strategy to create a new independent, publicly traded business from an existing subsidiary
- Shares distributed pro-rata to current shareholders as a dividend payment
- New entity takes assets, employees, or product lines from the parent, creating a more profitable standalone business
- A company can spin off a less productive devision from a new independent company
- There are not other investors included in this and the parent company doesn't have a controlling interest in the firm

D. Firms may voluntarily delist (active decision) when the benefits of public trading diminish: reduce the cost of capital, allow insiders to cash out, facilitate takeover activities and other strategic decisions
- A distressed publicly traded company might be taken private for restructuring by private equity or its management, with the intention of later selling or going public again

Answer: D

Question: 9

Disadvantages of private equity (PE)

A. Operational Restructuring
- Financial Restructuring
Important: most turnarounds and bankruptcy situations, both financial and operational restructuring must occur simultaneously to save the business
B. Volatile share prices
- Potential underperformance in weak markets
- High selling activity (= shareholders of the parent may not want the shares of the spinoff they received because the may not fit their investment criteria)
C. Investors can lose money of tracking stocks if the devision performs poorly (even if the parent company does well)
- They typically come with limited voting or no voting rights
- If the parent company goes into bankruptcy, creditors may have a claim on the tracking segment's assets (even if it is doing well financially)
D. Liquidity challenges: no ready-made order books
- Pricing negotiation: share pricing in PE is determined trough negotiations
- Rights of PE shareholders: PE shareholders' rights are decided case-by-case trough negotiations

Answer: D

Question: 10

Advantages of private equity (PE)

A. Liquidity access: access to liquidity as an alternative to traditional financing mechanisms
- Venture capital: supports early-stage companies and innovative ideas. Advise and monitor!
- Unorthodox growth strategies: implement growth strategies away from public market scrutiny
B. Giving shareholders a choice to retain parent shares or exchange them for new shares in the subsidiary
- Resembles a spin-off, but new firm shares are received only by shareholders opting to trade in the parent shares (and not on pro-rata basis as in spin-off transactions)
C. To reduce the cost of capital
- To allow insiders to cash out
- To facilitate takeover activities
- Strategic reasons: broadening the ownership base, capturing a first-mover advantage, increasing publicity or improving reputation
D. Reduce agency costs
- Creating tax shield
- Allow entry in new industry while maintaining a close relationship with the spun-off firm

Answer: A

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