Due in class, December 5th (.11 section) or 6th (.12 section).

Hard copy is strongly preferred, but if you can’t attend class, you can email solution by 6pm December 5th to Keith Siilats [ksiilats@stern.nyu.edu].

Can work in teams of up to three students. Be sure to list all team members’ names.

The questions are equal-weighted unless otherwise indicated.

1) Suppose a company is generating a high level of very steady income. Generally speaking, what sort of debt-equity ratio does the trade-off theory of capital structure recommend for this firm? Why? (3 sentences)

2) Suppose a company has low and erratic income, sometimes positive, sometimes quite negative. What sort of debt-equity ratio does the trade-off theory of capital structure recommend? Why? (3 sentences)

3) Suppose a company has determined that its equity is overvalued, and will underreact to the “bad news” of an equity issue. Should the company issue debt or equity to finance its next project? (Hint: this was non-BM6 material) (2 sentences)

4) Compute the present value of interest tax shields generated by these three debt issues. Consider corporate taxes only. The marginal corporate tax rate is 35%.
   - A $10,000, one-year loan at 8%
   - A 6-year loan of $11,000 at 9%. Assume no principal is repaid until maturity.
   - A $100,000 perpetuity at 7%.

5) Solve BM6 Practice Question #14, page 577. (The question is, are the #s consistent with the CAPM?)
6) Suppose that a manager tells you that he uses the following financing policy: “When I need money, I issue whatever form of finance is available at the lowest risk-adjusted cost.” Does that manager believe in efficient markets? What is the name we gave to the financing decision rule that he is using? (Hint: this was non-BM6 material) (2 sentences)

7) In practice, highly profitable firms tend to have relatively low debt-equity ratios. Is this fact more consistent with the trade-off theory of capital structure or the pecking-order theory of capital structure? Why? (4 sentences)

8) A lessee does not have to pay to buy the leased asset. Thus it’s said that “leases provide 100% financing.” Explain why this is not a true advantage (vis-à-vis debt financing) to the lessee.

9) Solve BM6 Practice Question #11, page 754. (Assume computer is depreciated using 5-year MACRS (p.130 of BM6), and assume leasing company always has income to shield)

10) What is meant by “moral hazard” and “adverse selection”? Explain why these effects tend to increase insurance premiums. (4 sentences)

11) Solve BM6 Practice Question #16, page 786.

12) Solve M6 Practice Question #6, page 814. (Assume the international capital markets are efficient.) (4 sentences)

13) When computing the NPV for an international project, which is the right procedure:
   (i) Forecast cash flows in foreign currency, discount at foreign cost of capital
   (ii) Forecast cash flows in domestic currency and discount at domestic cost of capital, assuming that all foreign cash flows are hedged (using the forward exchange rates).
   (iii) Doesn’t matter – (i) and (ii) are equivalent

14) List six potential solutions to the agency problem

15) Solve parts (a), (b), (c) of BM6 Practice Question #7, page 974 (Assume stock prices are determined using the Gordon perpetual growth model)