

## Chapter 23

23-1

a. No. The earnings per share will increase only if the return on assets exceeds the after tax cost of borrowing.

b. No. The risk will increase as leverage increases and the stock price may go down even with higher EPS.

c. If the increase in earnings per share more than offsets the higher risk from increased leverage, the price will go up.

23-2

a.

	<b>Without Borrowing</b>	<b>With Borrowing</b>
<b>EBIT</b>	20	20
<b>Interest Exp.</b>	0	4.8
<b>EBT</b>	20	15.2
<b>Taxes</b>	10	7.6
<b>Net Income</b>	10	7.6
<b>No. of Shares</b>	100,000	60,000
<b>EPS</b>	100	126.67

b. The interest rate on debt would have to be 12.5% for the EPS effect to disappear.

23-3

Forward contracts to buy equity are riskier than announcements of buybacks because they represent legal obligations to buy stock at a stated price. The firm does not have the option to back down.

23-4

I would recommend a split up of the firm into tobacco and food companies. A major barrier to such an action might be covenants in bond agreements protecting bondholders who might be hurt by such an action.

23-5

No. The split off will not solve the problem-because incumbent management (which is the problem) is still running the firm. I would recommend breaking up the firm and selling its component parts to outsiders, or a split off where incumbent management explicitly disavows control in the split off entities.

23-6

There may be several factors behind the positive reaction to spin offs. First, the spun off division may be worth more as an independent entity than as part of a larger company (a reverse synergy argument). Second, the spun off division may be freer to pursue plans it

could not pursue as part of the larger entity, either because of regulatory concerns or corporate culture. Finally, the very act of the spin off may force analysts to look at the value of the spun off entity and realize that they have been undervaluing it.

23-7

a. No. Given the preponderance of investment that is institutional investment and the fact that the price is only \$50 (rather than \$400 or \$500), I do not believe that this action is going to increase the investor base for the company.

b. While I would expect an initial positive reaction to the split, this increase will be sustained only if the firm follows up with positive news that confirms the signal sent by the split - i.e., that higher earnings and stock prices will follow.

23-8

I would expect the stock price reaction to be negative. A stock dividend is a cosmetic event with no cash flows associated with it and cannot replace a cash dividend.

23-9

The positive reaction can be explained by several factors. First, the action suggested that the management of the firm was aware that they had a problem and were willing to deal with it. Second, the split up units had more independence and were no longer burdened by the policies and practices of the other units. Third, it allowed each of the split up units to reveal their assets and earning power separately making it easier to value the component parts.

23-10

Spinning off the non-regulated businesses may relieve them of the burden of having to worry about the consequences of their actions for the regulated parent company. It will also allow them to set dividend and financing policy which is more consistent with their own interests.

23-11

Spin offs and splitoffs may make it easier to value firms since they isolate the assets of the entity being valued. It is easier to estimate risk parameters for the entity if it is traded separately. This benefit should be greatest when complex firms with financial statements that are difficult to break down and analyze.

23-12

The spin off will add to the value of the firm only if the corporate costs are excessive or unnecessary, and thus can be reduced or eliminated without hurting the divisional profitability. If on the other hand, the corporate costs represent costs that would now have to be borne by the independent divisions, the spin off should not increase value.

23-13

No. I do not think Nabisco's stockholders will be satisfied. While one of the objectives for the spin off - separating the contaminated tobacco division from the food division -

may have been accomplished, the other - removing management that they view as incompetent - would not.

23-14

If the issuance of the tracking stock leads analysts to look more closely at the internet unit, and as a result investors realize that the assets of the unit are worth more than originally thought, then the price of Disney would go up on the announcement.

Alternatively, if managers of the internet unit are to be compensated based on the price of the tracking unit, there will be a greater incentive for the unit's managers to perform well. This could also lead to a price increase.

23-15

For every five shares that a stockholder has in the old Disney, he would have had a value of  $\$30(5) = \$150$ ; subsequent to the tracking stock issuance, he would have  $(28)(5) + 12 = \$152$  in all. Hence each stockholder has benefited.