Session 11a: Post Class tests

1. DelMara Deli is a small, privately owned restaurant chain, where the owner has all of her wealth invested in the business. The unlevered beta for publicly traded restaurant chains is 0.90 and average R-squared of the market regressions for these companies is 25%. If DelMara has no debt, what is the cost of equity for DelMara's owner? (The risk free rate is 3% and the equity risk premium is 6%)
    a. 8.4%
    b. 13.8%
    c. 24.6%
    d. 18.0%
    e. None of the above
2. Some analysts use a beta estimated from accounting earnings, i.e., an accounting beta, to estimate a cost of equity for a private business. Which of the following is a problem with this approach?
    a. Accounting earnings gets estimated infrequently (once a quarter or year)
    b. Accounting earnings are often smoothed out
    c. Accounting earnings can be negative
    d. You are assuming that the private business owner is diversified
    e. All of the above
3. Inverness Inc. is a small, privately owned golf-equipment business. The owner is considering selling the company and is looking at potential buyers. Holding all else constant, which of the following is likely to pay the highest price and why?
    a. A private buyer (individual) who wants to run his own business
    b. A publicly traded sporting equipment company
    c. A venture capitalist
4. Gerard Enterprises is a publicly traded company. You are trying to estimate how much debt it has outstanding, to compute a cost of capital. Which of the following items would you not include in debt and why?
    a. Short term bank loans
    b. Commercial paper
    c. Corporate bonds
    d. Deferred Tax Liabilities
    e. None of the above
5. Lipscott Inc. is a publicly traded company that has $100 million in bank loan on its books, with a stated interest rate of 3% and $150 million in publicly traded bonds, with a coupon rate of 3.6%. The company currently has a bond rating of BBB, with a default spread of 1.5% over the risk free rate. If the current T.Bill rate is 1%, the ten-year T.Bond rate is 3.5% and the marginal tax rate is 35%, what is the pre-tax cost of debt?
    a. 3.36%
    b. 3.60%
    c. 5.00%
    d. 2.50%
    e. 3.50%