

Solutions

1. If you are an activist value investor, which of the following companies would you be most likely to target?
 - a. **Cheap companies that are under performing their peer group (in terms of profitability) and have low debt.**
 - b. Cheap companies that are out performing their peer group (in terms of profitability) and have low debt.
 - c. Cheap companies that are under performing their peer group (in terms of profitability) and have high debt.
 - d. Cheap companies that are out performing their peer group (in terms of profitability) and have high debt.
 - e. None of the above

Explanation: You want to buy a cheap company where there is potential for operating improvement (hence the comparison to the peer group) and the capacity to borrow money (allowing for an additional value increment from the debt and financing the acquisition).

2. Assume now that you are an activist investor and have taken a position in a company that has multiple businesses, some of which are generating much lower returns than others. Will divesting the worst businesses (those that generate the worst returns on capital) always increase the market value of the company?
 - a. Yes.
 - b. **No.**
Explain.

Explanation: The change in value from a divestiture will reflect the difference between the value of the business to you, as a continuing business, and the divestiture proceeds. Your worst businesses may have low value to you, on a continuing basis, but they may get you even less, if you try to divest them.

3. You have acquired a stake in a company with very little debt and are pushing the company to borrow more money. What effect will borrowing more money have on the company's costs of capital?
 - a. **It will increase the cost of equity and increase the cost of debt but may decrease the cost of capital.**
 - b. It will increase the cost of equity, the cost of debt and the cost of capital.
 - c. It will decrease the cost of equity and increase the cost of debt but will decrease the cost of capital.
 - d. It will decrease the cost of equity and increase the cost of debt but may decrease the cost of capital.
 - e. It will increase the cost of equity and increase the cost of debt but will have no effect on the cost of capital
 - f. It will decrease the cost of equity, the cost of debt and the cost of capital.

Explanation: Debt introduces a trade off: the tax benefits have to be weighed against the expected bankruptcy cost. As you borrow money, your equity risk (equity earnings will

become more volatile) and your default risk (because you have more interest expenses to cover) will both increase, but your cost of capital may decrease if the trade off works in your favor.

4. You have acquired a stake in a company that has accumulated a large cash balance. You are pushing for the company to return a significant portion of this cash to its investors in the form of a special dividend. In which of the following companies is that action likely to benefit stockholders?
- A high growth company that has lots of investment opportunities and a history of taking good investments.
 - A high growth company that has lots of investment opportunities and a history of taking neutral investments.
 - A mature company, with relatively few investment opportunities and a history of taking good investments.
 - A mature company, with relatively few investment opportunities and a history of taking neutral investments.
 - A mature company, with relatively few investment opportunities and a history of taking bad investments.**

Explanation: A company that has relatively few investment opportunities does not need the cash. In addition, its history of taking bad investments may mean that the cash balance is being discounted by the market. Returning it to investors will eliminate the discount.

5. If you are a small investor who plans to make money by following activist investors, which of the following offers the most promise of delivering high returns?
- Develop indicators that predict which companies are going to be targeted, before the targeting happens.**
 - Wait for the activist investor announcement that a company has been targeted and buy the shares on the announcement.
 - Invest in the company after activist investors have taken a position and hold for the long term.
 - Sell short on companies after activists have targeted the company.

Explanation: The biggest payoff in activist investing happens when the activist announces that he is targeting a firm. Hence, if you can try to find companies that are more likely to be targeted, you will partake in the winnings, even if you are right only a fraction of the time.