

PMIR BFM QUIZ 3 (C) SOLUTION

Time:10 mins

Please (✓) against the nearest correct answer. For each correct answer you get +1 mark & for each wrong answer -1.

1) If capital is to be rationed for only the current period, a firm should probably first consider selecting projects by descending order of ____.

- a) net present value
- b) payback period
- c) internal rate of return
- d) profitability index
- e) none of the above

2) CDE airlines paid Rs.4 as dividend last year on its equity shares, which is currently selling at Rs.100 per share. What is the market's required return on this investment if the dividend is expected to grow at 5% forever?

- a) 9 percent
- b) 9.2 percent
- c) 9.4 percent
- d) 9.6 percent
- e) none of the above

3) If a bond sells at a high premium, then which of the following relationships hold true? (P_0 represents the price of a bond and YTM is the bond's yield to maturity.)

- a) $P_0 < \text{par}$ and $\text{YTM} > \text{the coupon rate}$.
- b) $P_0 > \text{par}$ and $\text{YTM} > \text{the coupon rate}$.
- c) $P_0 > \text{par}$ and $\text{YTM} < \text{the coupon rate}$.
- d) $P_0 < \text{par}$ and $\text{YTM} < \text{the coupon rate}$.
- e) None of the above.

4) The current dividend on an equity share of FGH Telecom is Rs3.00. It is expected to enjoy an above-normal growth rate of 40 percent for 5 years. Thereafter, the growth rate will fall and stabilize at 12 percent. Equity investors require a return of 15 percent from the stock. What is the intrinsic value of the equity share of FGH Telecom?

- a) Rs.286
- b) Rs.292
- c) Rs.318
- d) Rs.327
- e) none of the above

5) Assume that ABC's firm has accurately calculated the net cash flows relating to an investment proposal. If the net present value of this proposal is greater than zero and the firm is not under the constraint of capital rationing, then the firm should:

- a) Calculate the IRR of this investment to be certain that the IRR is greater than the cost of capital.
- b) Compare the profitability index of the investment to those of other possible investments.
- c) Calculate the payback period to make certain that the initial cash outlay can be recovered within an appropriate period of time.
- d) Accept the proposal, since the acceptance of value-creating investments should increase shareholder wealth.
- e) None of the above

6) KLM has estimated that a proposed project's 10-year annual net cash benefit, received each year end, will be Rs.2,500 with an additional terminal benefit of Rs.5,000 at the end of the tenth year. Assuming that these cash inflows satisfy exactly KLM's required rate of return of 8 percent, calculate the initial cash outlay.

- a) Rs.16,775
- b) **Rs.19,090**
- c) Rs.25,650
- d) Rs.30,600
- e) none of the above

7) A firm has fixed operating costs of \$253,750, a sales price per unit of \$100, and a variable cost per unit of \$65. The firm's operating breakeven point in dollars is

- A. **\$725,000.**
- B. \$700,000.
- C. \$906,250.
- D. \$390,385.
- E. none of the above.

8) If the intrinsic value of a stock is greater than its market value, which of the following is a reasonable conclusion?

- a) The stock has a low level of risk.
- b) The stock offers a high dividend payout ratio.
- c) **The market is undervaluing the stock.**
- d) The market is overvaluing the stock.
- e) None of the above

9) Which of the following statements is correct?

- a) If the NPV of a project is greater than 0, its PI will equal 0.
- b) If the IRR of a project is 0%, its NPV, using a discount rate, k , greater than 0, will be 0.
- c) **If the PI of a project is less than 1, its NPV should be less than 0.**
- d) If the IRR of a project is greater than the discount rate, k , its PI will be less than 1 and its NPV will be greater than 0.
- e) None of the above.

10) A firm has EBIT of \$375,000, interest expense of \$75,000, preferred dividends of \$6,000 and a tax rate of 40 percent. The firm's degree of financial leverage at a base EBIT level of \$375,000 is _____.

- a) 0.97
- b) **1.29**
- c) 1.27
- d) 1.09
- e) none of the above