

FIN325 - Homework 2

Due : Thursday, September, 30th, by midnight, on canvas, pdf only

Problem 1 (20pts)

In this question as in my cash-flow road map, all cash flows are understood to be cash flows from operations.

A corporation's trailing EBITDA ($EBITDA_0$) is \$100M. EBITDA will grow by 20% each year over the next three years. For instance, EBITDA in year 1 is \$120M. The corporation's investment in operating assets will be constant at \$20M over each of the next three years while depreciation will be constant at \$30M. Its tax rate is 25%. The corporation has only one piece of debt, a fully amortizing loan with outstanding principal \$50M, an interest rate of 10%, and three fixed payments left to maturity: one payment in year 1, one in year 2, and one in year 3. There will be no other cash-flows during the entire time for this corporation.

What will the corporation's FCFE be in year 3?

Problem 2 (20pts)

A corporation is going to generate \$3,000 in FCFF over the next year ($FCFF_1 = 3,000$.) Expected FCFF then grows by 2.75% a year, until the corporation dies after exactly T periods. Investors expect a 8% return when they invest in this company.

1. If $T = 10$, what is the market value of operating assets and growth opportunities?
2. Still assuming $T = 10$, if the holy trinity held exactly (it doesn't, of course) and at this market value, what would be the required rate of return?
3. How large must T be for the gap between the true required rate and that predicted by the holy trinity to be less than 1% ?

Problem 3 (20pts)

A corporation is going to generate \$100,000 in FCFF over the next year ($FCFF_1 = 100,000$.) For this corporation, FCFF grows by 2% a year, for ever, as do all of its other cash flows (I, T, \dots). The market value of the corporation's operating asset and

growth opportunities is \$1M. The corporation's forward investment-to-value (capex intensity, $\frac{I_1}{EV_0}$, be careful this is not the same as $\frac{I_0}{EV_0}$) and tax-to-value (tax intensity, $\frac{T_1}{EV_0}$, be careful this is not the same as $\frac{T_0}{EV_0}$) ratio are 2% each. What is the corporation's trailing EBITDA multiple?

Problem 4 (20pts)

Consider a project whose EBIT, each period and for ever, is either \$80M or \$100M with equal probability. The project is financed with an interest-only perpetuity with face value \$300M. Debt-holders require a 7% return. Investment is \$20M each period, as is depreciation. The company pays $\tau = 30\%$ in income taxes. The project has market value \$1bn. What is $E(r^E)$?

Problem 5 (20pts)

A corporation has the option to prepay (call) a bond with 5 years to maturity, \$100M in remaining principal, a 10% yearly rate, fixed and monthly payments. It can replace it with a 5-year bond with the same payment structure but a 9% yearly rate. It believes rates will fall no further. Prepayment penalties are 2% of outstanding principal.

The CFO forgot what they heard in FIN325 so they are using the wrong discount rate. Specifically, they are discounting the monthly savings at a 5% rate (yearly terms) because, they say, that's what they can earn on their short-term investments. Using that wrong discount rate, compare the NPV of refi when you finance the prepayment penalties using the new bond issue (=fold the penalty into the new bond), and when you don't. Which option has the highest NPV according to those wrong calculations? Why (two sentences at the most)?

To put things a slightly different way, you need to assume that, throughout, the CFO is using the wrong discount rate, namely that they discount everything at 5%. Then, under that assumption, carry out two calculations. What is the NPV of refi if they pay for prepayment out of their own cash? What is the NPV of refi if they fold the prepayment penalty into the new bonds? Are the two numbers the same like they were in class when we used the correct discount rate? Why is this happening?