CHAPTER 5

CONCEPT REVIEW QUESTIONS

1. Why are shareholders viewed as "residual owners"? What rights do they get in exchange for taking more risk than creditors and preferred shareholders take?

Common stockholders are residual owners because they are entitled to receive cash only after all other creditors and preferred shareholders have been paid. Because common stockholders receive their compensation from "the residual" or whatever is left over after everyone else has been paid, their claim is especially risky. As compensation for taking that risk, common stockholders can earn much higher returns than can creditors and preferred stockholders, and common stockholders also have the right to vote on important corporate matters.

2. Most large Japanese corporations hold their annual shareholders' meeting on the same day and require voting in person. Therefore, it is impossible for a shareholder who owns shares in more than one company to go to more than one annual meeting. What does this practice say about the importance and clout of individual shareholders in Japanese corporate governance?

Since it is clearly impossible for a person who owns stock in more than one company to be present at more than one annual meeting, these practices indicate that individual shareholders have very little decision-making power in Japanese corporations.

3. Why would companies issue dual classes of shares with different voting rights?

Different classes of shares are required to match a company's diverse financial needs.

4. What is the difference between a *primary market* and a *secondary market*?

The primary market refers to when a firm first issues a particular security. The secondary market is where the daily back and forth trading of that security takes place.

5. What do firms and their investment bankers hope to learn on the road show?

The purpose of the road show is to obtain a preliminary assessment of how much demand there will be for the firm's stock at different possible prices. This helps the banker set the offering price.

6. How are underwriters compensated?

Underwriters earn the underwriting spread which typically equals about seven percent of the money raised in a an equity IPO and about 0.5 percent in a large debt offering.

7. When you buy shares in the secondary market, does the firm that issued the shares receive cash?

No. In a secondary market transaction, cash simply flows from the investor buying the shares to the investor selling the shares. The firm is not a party to the transaction. Firms receive money when they sell shares in the primary market.

8**.** List several differences between the NYSE and the Nasdaq.

The most obvious difference is that the NYSE is a physical market located in New York City, while the Nasdaq is an electronic market with no single central location. The NYSE usually has higher trading volume (in terms of dollars traded) and the value of securities traded there is greater than the value of stocks on the Nasdaq.

9**.** Why is it appropriate to use the perpetuity formula from Chapter 3 to estimate the value of preference shares?

This formula applies to a level stream of cash flows that never ends. Preferred shares generally pay a fixed dividend, and they do not have a specific maturity date.

10. When a shareholder sells shares, what is being sold? What gives a share value?

What is being sold is the right to receive all future cash payments paid by the company to stockholders. It is the prospect of receiving cash payments over time that gives common shares their value.

11. What would happen to the price of Arriva if the market's required return on its shares increased?

The price would fall because the market would be discounting the firm's cash flows at a higher rate.

12**.** How can the *free cash flow approach* to valuing an enterprise be used to resolve the valuation challenge presented by firms that do not pay dividends? Compare and contrast this model with the dividend valuation model.

The FCF model does not require any assumption about when a firm will distribute cash dividends to investors. Instead, the model examines the cash flow generated by a firm, making adjustments for cash flow that must be reinvested to generate growth opportunities. Like the dividend growth model, the FCF approach tries to measure how much cash a firm can distribute to shareholders over time.

13. Can we use any of the models above when the company is neither paying dividends nor has positive cashflow? What assumptions would we need to make to apply some of these models?

To apply the FCF model in this context we would need to assume that a firm can have a negative value.

14**.** Why might the terms *book value* and *liquidation value,* used to determine the value of a firm, be characterized as viewing the firm as "dead rather than alive"? Explain why those views are inconsistent with the discounted cash flow valuation models.

Book value measures the costs of a firm's assets, net of accumulated depreciation. Subtract off the historic value of the firm's liabilities and you have the book value of the firm's equity. Liquidation value measures how much cash a firm could raise from a one-time sale of its assets (again, subtracting off what is needed to pay creditors). Neither of these measures is forward-looking as is the discounted cash flow approach. If the firm is a going concern, then a forward-looking approach is preferred because it can potentially capture the value of future growth opportunities.

15. Why is it dangerous to conclude that a firm with a high P/E ratio will probably grow faster than a firm with a lower P/E ratio?

The P/E ratio might be high simply because E is unusually small in a particular quarter or year. Also, the P/E ratio can be influenced by how risky the firm is. If we have two firms with identical expected growth rates and identical current earnings, the firm that is less risky may have a higher P/E ratio because investors discount its future earnings at a lower rate than they use to discount the earnings of the riskier firm. Finally, we have noted in several places in this chapter that growth rates are notoriously difficult to predict.