27 CAPITAL STRUCTURE

1. The executive management of Global Capital Advisors (GCA) is considering making a new acquisition that needs a significant amount of new capital. Based on the pecking order theory, GCA's most appropriate financing decision is to use:
   (A) debt financing, because it is the cheapest financing option.
   (B) equity financing, because it does not increase the firm's leverage.
   (C) internal financing, because it is least likely to send a negative signal to investors.

2. According to the static trade-off theory:
   (A) the amount of debt used by a company should decrease as the company's corporate tax rate increases.
   (B) new debt financing is always preferable to new equity financing.
   (C) there is an optimal proportion of debt that will maximize the value of the firm.

3. A firm is planning a $25 million expansion project. The project will be financed with $10 million in debt and $15 million in equity stock (equal to the company's current capital structure). The before-tax required return on debt is 10% and 15% for equity. If the company's tax rate is 35%, what cost of capital should the firm use to determine the project's net present value?
   (A) 9.6%.
   (B) 12.5%.
   (C) 11.6%.

4. A financial services company requires all new hires in senior management positions to sign noncompete agreements. The costs associated with these noncompete agreements are an example of:
   (A) monitoring costs, a component of pecking order theory.
   (B) bonding costs, a component of the net agency costs of equity.
   (C) bonding costs, a component of pecking order theory.

5. Under the assumptions of Modigliani and Miller's Proposition I, the value of a firm:
   (A) is not affected by its capital structure.
   (B) increases as the use of debt financing rises.
   (C) decreases as the use of equity financing rises.

6. Under the static trade off theory, the optimal capital structure of a firm is at the point where the:
   (A) value of an unlevered firm is at its maximum.
   (B) difference between the value of a levered firm and unlevered firm is at its maximum.
   (C) cost of financial distress is at its minimum.

7. The conclusion of Modigliani and Miller's capital structure model with taxes is that:
   (A) there is a trade-off between tax savings on debt increased risk of bankruptcy.
   (B) capital structure decisions do not affect the value of a firm.
   (C) firms should be financed with all debt.

8. According to the static trade-off theory of capital structures, the:
   (A) cost of equity is upward sloping.
   (B) value of the tax shield from additional borrowing initially increases, then decreases.
   (C) weighted average cost of capital (WACC) initially increases, then decreases.

9. Elenore Rice, CFA, is asked to determine the appropriate weighted average cost of
   - capital for Samson Brick Company. Rice is provided with the following data:
   - Debt outstanding, market value $10 million
   - Common stock outstanding, market value $30 million
   - Marginal tax rate 40%
   - Cost of common equity 12%
   - Cost of debt 8%

   Samson has no preferred stock. Assuming Samson's ratios reflect the firm's target capital structure, Samson's weighted average cost of capital is closest to:
   (A) 9.8%.
   (B) 10.4%.
   (C) 10.2%.

10. An analyst covering the reinsurance sector observes that the capital structure of three of the covered firms recently deviated from their targets. That analyst should be most concerned with:
    (A) Firm C, whose equity weight increased relative to target given the minimum lot Size requirement when it issued new equity.
    (B) Firm B, whose debt weight increased relative to target following the issuance of new debt.
    (C) Firm A, whose equity weight declined relative to target given a drop in the market value of the firm's equity.

11. Removing the assumption of no taxes, but keeping all of Modigliani and Miller's other assumptions, which of the following would be the optimal capital structure for maximizing the value of a firm?
    (A) 100% equity.
    (B) 100% debt.
    (C) 50% debt and 50% equity.

12. Which of the following statements regarding Modigliani and Miller's Proposition II with taxes is most accurate?
    (A) The value of the firm is maximized at the point where the WACC is minimized.
    (B) Companies should use a 50% equity/50% debt capital structure to maximize value.
    (C) The tax shield provided by debt causes the WACC to increase as leverage increases