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Key for Quiz A: 10/15/12

Assume that PanditOut Inc. announces plans to issue additional debt and use the proceeds to repurchase shares of common stock. At the announcement, the prices of PanditOut's common shares and its outstanding bonds fell. Excluding tax issues, how would you explain these reactions?

1) The increased debt has (reduced the value of the firm) because of (higher expected bankruptcy costs)

=> higher debt creates a (higher chance of bankruptcy)

Direct costs = (costs to hire outside experts) during the bankruptcy process

✓ Examples: Cost to hire accountants, lawyers, and investment bankers

Indirect costs = costs that stem from (changes in behavior towards the firm)

✓ Examples: loss of customers, suppliers and trade credit, best employees, value as employees fight fires rather than maximizing value; greater difficulty collecting from customers, fire sale of assets, losses by creditors as firm defaults on what it owes them

2) The increased debt has reduced the value of the firm due to (foregone future positive NPV project)

✓ => stockholders may have a net loss on projects if they would have to provide the funding but would

→ share the benefits with the ^{bond} stockholders

Scale
11 = 75
10 = 73
8
7 = 68
5 = 64
4 = 61
- 3 = 58

2 = 56
1 = 54
0H = 52
0+ = ~~48~~ 48