

Quiz A for 2:30 Class: 10/23/13

Name _____

Short Answer 1 (15 points): Gamma Air's stock has a market value of \$200 million and its debt has a market value of \$100 million. You currently own \$195,000 of Gamma Air stock and \$105,000 of Gamma Air bonds. What transactions would be required for you to have an unlevered position in Gamma Air?

Short Answer 2 (15 points): Briefly explain how debt helps resolve stockholder-manager conflict after it is issued.

Problem (75 points): Space Balloon Inc. has a 10% chance of earning \$8 million, a 30% chance of earning \$17 million, a 40% chance of earning \$23 million, and a 20% chance of earning \$36 million. If the corporate tax rate equals 35%, the personal tax rate on equity income equals 15%, and the personal tax rate on ordinary income equals 40%, what is the optimal level of interest expense for Space Balloon?

Note: Calculations required. You will only receive partial credit if you show your work.

Wall Street Journal Questions are on the back of this page.