Quiz B for 1:00 Class: 3/4/13 **Name _______________________________**

Assume you own all of the stock in an unlevered firm with a market value of $200,000. The firm is considering whether or not it should issue $60,000 of risk-free debt paying an interest rate of 2% and use the proceeds to repurchase $60,000 of your shares. Note: Some calculations are necessary to answer each of the following.

a. Assume that markets are perfect. What is the value of your stock after the debt issue/share repurchase? How much has your wealth changed because of the debt issue/share repurchase? What key issue drives this result?

b. Assume that instead of markets being perfect, the corporate tax rate is 45%. What is the value of your stock after the debt issue/share repurchase? How much has your wealth changed as a result of the debt issue/share repurchase? What key issue drives the difference between your answers in a. and b.?

c. Assume (as in part b) that the corporate tax rate is 45%, but also assume that the personal tax rate on interest income is 50% and that the personal tax on equity income is 15%. What is the value of your stock after the debt issue/share repurchase? How has your wealth changed as a result of the debt issue/share repurchase (relative to if the firm does not have a debt issue/share repurchase)? What key issue drives the difference between your answers in b. and c.?

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