Quiz B for 1:00 Class: 03/27/13 Name ____________________________

Assume Hoops Inc. has outstanding debt that matures for $5,000,000 six years from today.

a. Sketch a graph of the potential payoffs on Hoops stock as a function of the value of the firm's assets three years from today. Show the specific payoffs if the value of the firm's assets equal $4,000,000 and $7,000,000 six years from today. Clearly label and identify each payoff.

b. From the perspective of viewing Hoops' risky bonds as equivalent to a portfolio of options and owning the firm's assets, sketch the payoffs on the portfolio, owning the firm's assets, and the options if Hoops' assets end up being worth $4,000,000 and $7,000,000 six years from today. Clearly label and identify each payoff.

c. Assume that due to a covenant violation, the amount owed bondholders in six years jumps to $6,000,000. Explain in terms of options how this change affects the value of the firm's outstanding stock and bonds.

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