

Chapter: Chapter 01: Why Value Value?

Multiple Choice

1. Which one of the following actions would help a company create long-term value?

- a) Focus on keeping costs at a minimum.
- b) Find the optimal debt-to-equity ratio.
- c) Seek and exploit new sources of competitive advantage.
- d) Monitor and follow macroeconomic trends.

Ans: [c]

Response: []

2. Which of the following have been found to occur in companies that adopt long-term value-creation policies?

- I. Higher customer satisfaction.
 - II. Higher number of acquisitions.
 - III. Better treatment of former employees.
 - IV. A higher level of corporate responsibility.
- a) I and II only.
 - b) I, III, and IV only.
 - c) II and III only.
 - d) III and IV only.

Ans: [b]

Response: [These results are congruous with a healthy, well-run firm.]

3. The conservation of value corollary of the value-creation principle says that:

- a) Reducing costs is the first step in creating value.
- b) Return on invested capital must increase over time to create value.
- c) Anything that does not increase cash flows does not create value.
- d) Acquisitions always create more value than divestitures.

Ans: [c]

Response: []

4. Which of the following were fundamental flaws in the decisions made by participants in the securitized mortgage market that contributed to its boom through 2007?

- I. Leverage creates value.
- II. Lower costs create value.
- III. Diversification creates value.
- IV. Lower cost of capital creates value.

- a) I and II only.
- b) I and III only.
- c) II and III only.
- d) III and IV only.

Ans: [b]

Response: []

5. Under which condition will a fast-growing firm create value?

- a) It will create value in any circumstance.
- b) If the return on invested capital (ROIC) is greater than the cost of obtaining funds.
- c) If the return on invested capital (ROIC) is less than the cost of obtaining funds.
- d) If the firm increases market share.

Ans: [b]

Response: []

6. Data from Europe and the United States found that the correlation between value creation and employment in the company has been:

- a) Positive.
- b) Negative.
- c) Essentially zero.

Ans: [a]

Response: []

7. Paying attention to which of the following tends to lead to a company doing well in the stock market?

- I. Growth.
- II. Price-to-earnings ratio.
- III. Earnings per share.
- IV. Return on invested capital.

- a) I and II only.
- b) II and III only.
- c) I and IV only.
- d) II, III, and IV only.

Ans: [c]

Response: [The two sources of value creation are growth and return on invested capital.]

8. Which of the following was most responsible for the Internet boom and bust?

- a) The Y2K bug.
- b) Increased foreign competition.
- c) A misapplication of the principle of leverage.
- d) A single-minded focus on growth at any cost.

Ans: [d]

Response: [Managers assumed growth creates value while ignoring the fact that return on invested capital must be above the cost of capital in order to create value.]

True/False

9. The faster companies can increase their revenues and deploy more capital at attractive rates of return, the more value they create.

Ans: [True]

Response: []

10. Relative to its ability to create value, managers tend to neglect changing capital structure.

Ans: [False]

Response: [Managers often use changes in capital structure and changes in accounting practices in an attempt to create value, but both are generally ineffective.]

Multiple Choice

11. The empirical evidence shows that the link between the value created by the acquisition of another company and earnings per share (EPS):

- a) Is strong and positive.
- b) Does not exist.
- c) Is weak and negative.
- d) Is strong and negative.

Ans: [b]

Response: []

True/False

12. Aggressive use of leverage is the theme that links most major financial crises.

Ans: [True]

Response: []

Short Answer

13. Explain the challenge competition plays in creating value in the long run and what this means for the firm that wishes to create value in the long run.

Ans: [Competition tends to erode competitive advantages and, with them, returns on invested capital. Therefore, companies must continually seek and exploit new sources of competitive advantage if they are to create long-term value. To that end, managers must resist short-term pressure to take actions that create illusory value quickly at the expense of the real thing in the long term.]