Investment Banking Technical Interview Practice Test (Sample)

Study Guide

Everything you need from our exam experts!

Questions

1. **Who ranks higher in creditor hierarchy during bankruptcy?**
    - A. Common stockholders
    - B. Bondholders
    - C. Preferred stockholders
    - D. Debenture holders

2. **Why might a company choose to reinvest excess cash instead of distributing it as dividends?**
    - A. To improve shareholder relations
    - B. To fund future growth and expansion opportunities
    - C. To avoid regulatory scrutiny
    - D. To enhance short-term stock performance

3. **Which of the following is classified as a current liability?**
    - A. Long-term Debt
    - B. Accounts Payable
    - C. Deferred Revenue
    - D. Goodwill

4. **How are purchase and exit multiples typically determined in an LBO model?**
    - A. By assessing what comparable companies are trading at
    - B. Based on projected future revenues
    - C. Using historical data of the industry
    - D. From internal company valuations

5. **What does the cost of debt typically represent in a discounted cash flow analysis?**
    - A. The total revenue generated by the company
    - B. The interest payments made by the company on its debts
    - C. The amount of equity raised from investors
    - D. The depreciation expense related to assets

6. Which statement is true regarding debt in a capital structure?

- **A. All debt must be repaid before any equity holder receives payment in liquidation**
- **B. Debt provides guaranteed returns to shareholders**
- **C. Debt always has a lower cost of capital than equity**
- **D. Debt investors have voting rights in the company**

7. What is the result of a strong positive correlation between two stocks?

- **A. They tend to move in opposite directions**
- **B. They remain static regardless of market conditions**
- **C. They typically move up or down together**
- **D. They are unrelated in performance**

8. Which statement best describes Goodwill after an acquisition?

- **A. It typically increases over time**
- **B. It is usually reassessed for impairment periodically**
- **C. It is directly proportional to cash flows**
- **D. It is included in current liabilities**

9. What might be added back to EBITDA to assess a company's financial health?

- **A. Recurring operational expenses**
- **B. Legal expenses**
- **C. Routine maintenance costs**
- **D. Monthly utility costs**

10. Which of the following statements best describes the secondary market?

- **A. The market where new securities are issued**
- **B. The market where existing stocks or bonds are traded**
- **C. The market for treasury bonds only**
- **D. The market for IPOs only**

Answers

1. **B**
2. **B**
3. **B**
4. **A**
5. **B**
6. **A**
7. **C**
8. **B**
9. **B**
10. **B**

Explanations

1. Who ranks higher in creditor hierarchy during bankruptcy?

A. Common stockholders

B. Bondholders

C. Preferred stockholders

D. Debenture holders

During bankruptcy proceedings, the order of payment to creditors is crucially determined by the hierarchy of claims on a company's assets. Bondholders rank higher than common stockholders, preferred stockholders, and debenture holders in this hierarchy. Bondholders are considered debt holders with a claim to the company's assets and income before other types of security holders. They are typically secured or unsecured creditors, depending on the specifics of the bond issue. In the case of bankruptcy, their claims are prioritized over equity holders, which includes common and preferred stockholders who face a higher risk of losing their investment. Debenture holders, while also a form of debt, could be senior to other forms of securities depending on the terms laid out in the debt agreement, but generally speaking, they are not regarded as a higher tier compared to bondholders. Thus, bondholders indeed take precedence in receiving repayments from the company's remaining assets during bankruptcy proceedings, affirming their critical role in the creditor hierarchy.

2. Why might a company choose to reinvest excess cash instead of distributing it as dividends?

A. To improve shareholder relations

B. To fund future growth and expansion opportunities

C. To avoid regulatory scrutiny

D. To enhance short-term stock performance

A company might choose to reinvest excess cash instead of distributing it as dividends primarily to fund future growth and expansion opportunities. When a business has surplus cash, it often seeks to utilize those funds to invest in initiatives that can generate higher returns than the cost of capital. This can include acquiring new assets, launching new products, entering new markets, or enhancing existing operations—all aimed at accelerating growth and increasing long-term shareholder value. By focusing on reinvestment, the company aims to position itself for competitive advantage and sustainable profitability. This strategic decision aligns with the idea that reinvesting profits can create greater value in the long run, as opposed to merely paying out cash, which might not support significant value creation. While improving shareholder relations can be a benefit of making value-adding investments, the primary motivation is centered around growth opportunities. Similarly, avoidance of regulatory scrutiny is generally not a primary concern in the context of cash management, and enhancing short-term stock performance typically does not justify long-term strategic decisions like reinvestment, which usually focuses on sustainable growth rather than immediate stock price impacts.

3. Which of the following is classified as a current liability?

A. Long-term Debt

B. Accounts Payable

C. Deferred Revenue

D. Goodwill

Accounts Payable is classified as a current liability because it represents money that a company owes to its suppliers and creditors for goods and services received but not yet paid for. Typically, these obligations are expected to be settled within a year, aligning perfectly with the definition of current liabilities, which include financial obligations that are due for payment within one operating cycle or one year, whichever is longer. This classification reflects the company's short-term financial health and liquidity position, ensuring that stakeholders can assess its ability to meet near-term obligations. In contrast, long-term debt represents obligations that extend beyond one year, while deferred revenue is a liability but specifically tied to performance obligations. Goodwill is an intangible asset resulting from acquisitions and does not fall within either liability category.

4. How are purchase and exit multiples typically determined in an LBO model?

A. By assessing what comparable companies are trading at

B. Based on projected future revenues

C. Using historical data of the industry

D. From internal company valuations

Purchase and exit multiples in a Leveraged Buyout (LBO) model are typically determined by assessing what comparable companies are trading at. This approach leverages market data to gauge the value that similar companies are attracting in terms of valuation, often measured through metrics such as EBITDA, revenue, or earnings. Comparables provide a market-backed context for assessing an appropriate entry and exit multiple, which is crucial since it reflects investors' perceptions and the current competitive landscape. By examining how other firms within the same industry are valued, analysts can establish a solid gauge for estimating future performance and the exit value. While projected future revenues offer insight into projected business growth, they do not directly inform the valuation multiples as comprehensively as current market comparisons. Historical data may reflect past performance but can be stale or not indicative of market trends. Internal company valuations, though valuable for assessing a specific business’s worth, may not incorporate external market sentiments which are critical in determining those multiples. Thus, the assessment of comparable companies’ trading metrics provides the most relevant and actionable data for setting purchase and exit multiples in an LBO context.

5. What does the cost of debt typically represent in a discounted cash flow analysis?

A. The total revenue generated by the company

B. The interest payments made by the company on its debts

C. The amount of equity raised from investors

D. The depreciation expense related to assets

In a discounted cash flow (DCF) analysis, the cost of debt symbolizes the effective rate that a company pays on its borrowed funds. This cost reflects the interest payments made by the company on its various debts, such as loans and bonds. It serves as a critical component when calculating the weighted average cost of capital (WACC), which is used to discount future cash flows to present value. The cost of debt is pertinent because it indicates how much a company must pay to service its debt, thus impacting its overall valuation. Accurately incorporating the cost of debt into a DCF ensures that potential investors understand not only the operational performance of a business but also the financial risks associated with its debt obligations. Recognizing the importance of interest payments helps analysts evaluate the sustainability of a company's financial structure and its ability to generate returns that exceed its cost of capital. Understanding this fundamental aspect helps clarify why the other options do not align with the concept of cost of debt in DCF analysis; they pertain to different financial metrics or components unrelated to the costs incurred from borrowing.

6. Which statement is true regarding debt in a capital structure?

A. All debt must be repaid before any equity holder receives payment in liquidation

B. Debt provides guaranteed returns to shareholders

C. Debt always has a lower cost of capital than equity

D. Debt investors have voting rights in the company

In the context of capital structure, the statement that all debt must be repaid before any equity holder receives payment in liquidation is true. This reflects the priority of claims in the event of a company's liquidation. When a company is liquidated, creditors—those who hold debt instruments—must be paid first before any distributions can be made to equity holders. This establishes a hierarchy of claims, where debt holders have a contractual right to receive their payments before any residual value can be distributed to shareholders. The other choices introduce concepts that do not accurately reflect the nature of debt in relation to equity. Debt does not inherently guarantee returns to shareholders; such returns are contingent on the company's financial performance. Furthermore, while it is common for debt to have a lower cost of capital compared to equity, this is not universally true as various factors such as market conditions and the specific risk profile of a company can influence the cost of capital. Finally, debt investors typically do not have voting rights in the company; those rights are generally reserved for equity holders. Thus, option A stands out as the accurate statement regarding the treatment of debt in a company's capital structure.

7. What is the result of a strong positive correlation between two stocks?

A. They tend to move in opposite directions

B. They remain static regardless of market conditions

C. They typically move up or down together

D. They are unrelated in performance

A strong positive correlation between two stocks indicates that they typically move in the same direction. When one stock experiences an upward price movement, the other is likely to do the same, and conversely, if one stock declines, the other is likely to decline as well. This relationship stems from similar underlying influences, such as market sentiment, sector performance, or macroeconomic factors. In financial analysis, a positive correlation close to +1 implies that the stocks often react to market changes in a synchronized manner. This understanding is crucial for investors when making portfolio decisions, as it helps in managing risk and optimizing returns. Investors might choose to diversify their investments by including assets that are less correlated or negatively correlated to mitigate the risks associated with market movements. The other options do not accurately reflect the concept of positive correlation. Stocks moving in opposite directions indicates a negative correlation, while remaining static regardless of market conditions suggests no correlation at all. Additionally, stocks that are unrelated in performance indicate a lack of correlation, which contradicts the idea of a strong positive correlation.

8. Which statement best describes Goodwill after an acquisition?

A. It typically increases over time

B. It is usually reassessed for impairment periodically

C. It is directly proportional to cash flows

D. It is included in current liabilities

Goodwill represents the premium that a company pays over the fair value of the net identifiable assets of a business during an acquisition. It reflects intangible assets such as brand reputation, customer relationships, and synergies expected from the acquisition. The correct answer indicates that goodwill is usually reassessed for impairment periodically, which is essential for accurate financial reporting. Companies must review goodwill at least annually or more frequently if there are indicators that its value may have declined. Impairment occurs when the carrying amount of goodwill exceeds its fair value, prompting a write-down that must be reflected in the financial statements. This reassessment ensures that the goodwill on the balance sheet accurately represents its current value, given that it does not have a finite life. In contrast, goodwill does not typically increase over time; rather, it remains static until impairments occur or a new acquisition happens. It also does not have a direct correlation to cash flows, as goodwill is an accounting measure rather than a cash-generating asset. Additionally, goodwill is classified as an intangible asset, located on the asset side of the balance sheet, not in current liabilities. Thus, the notion of periodic reassessment for impairment is critical to accurate accounting and reflects the importance of monitoring the value of acquired intangibles.

9. What might be added back to EBITDA to assess a company's financial health?

A. Recurring operational expenses

B. Legal expenses

C. Routine maintenance costs

D. Monthly utility costs

When assessing a company's financial health through EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization), it is important to add back costs that are considered non-recurring or extraordinary. Legal expenses often fall into this category, as they can vary significantly from one period to another and may include costs related to lawsuits, settlements, or regulatory matters that are not part of the company's normal operations. By adding back legal expenses to EBITDA, analysts can provide a clearer picture of the ongoing operational earnings of the company, excluding the impact of these one-time or irregular costs. This allows investors and stakeholders to better assess the core profitability and performance of the business without the distortion caused by atypical legal costs. In contrast, recurring operational expenses, routine maintenance costs, and monthly utility costs are considered regular business expenses and are typically part of the normal EBITDA calculation. They represent the ongoing costs of running the business and do not provide the same insights into extraordinary financial events that legal expenses might. Thus, adding back legal expenses provides a means to evaluate the company's actual performance more accurately.

10. Which of the following statements best describes the secondary market?

A. The market where new securities are issued

B. The market where existing stocks or bonds are traded

C. The market for treasury bonds only

D. The market for IPOs only

The secondary market refers to the platform where previously issued securities, such as stocks and bonds, are bought and sold among investors. Unlike the primary market, which is focused on the issuance of new securities directly from companies to investors, the secondary market deals exclusively with securities that have already been issued and are being traded by investors. This trading can take place on stock exchanges or over-the-counter (OTC), and it facilitates liquidity, allowing investors to buy and sell their investments easily. The secondary market plays a crucial role in price discovery, providing a way for market participants to assess the value of their investments based on supply and demand dynamics. In contrast, the other options refer to different aspects of the financial markets. One option mentions the issuance of new securities, which pertains to the primary market. Another option restricts the scope to treasury bonds, which is too narrow since the secondary market encompasses a wide range of securities beyond just treasury bonds. The final option focuses on IPOs, which again relates to the primary market, as IPOs (Initial Public Offerings) are the processes through which new shares are offered to the public for the first time. Thus, the correct description of the secondary market is that it involves the trading of existing stocks and bonds.