Vault.com Guide to Finance Interviews, 3rd Edition

D. Bhatawedekhar

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If you're looking for a job with an investment bank, commercial bank, mutualfund, or as a finance official at a corporation, you're bound to get technicalfinance questions during your interviews. The Vault Reports Guide to Finance Interviews is a must for anyone preparing for interviews. This 150-page guide is packed with key finance concepts and more than 80 sample questions to help you ace your interviews.

A few things you'll find in The Vault Reports Guide to Finance Interviews.

Valuation techniques Bonds and interest rates Stock, including stock splits, buybacks, and preferred stock Basic accounting concepts, including income statements, cash flow and balance sheets Mergers and acquisitions Currencies Option and derivatives Brainteasers, guesstimates, and other stress questions Skills and personality traits finance interviewers are looking for Key terms

And much more!

Excerpts from The Vault Reports Guide to Finance Interviews:

You say accretive, I say dilutive

A merger can be either accretive or dilutive. A merger is accretive when a firm with a higher price to earnings ratio (we'll call the company "Company 1," and label it's P/E ratio "P/E1") acquires a firm of a lower P/E ratio (which we will label P/E2). Why do we call the merger accretive?

The company's new earnings will be E1 + E2. Let's call this Enew. Usually, the new company will maintain the P/E ratio of the acquiring firm. Post-acquisition, it will be valued as P/E1 x earnings.

However, the amount that Company 1 had to pay was only PE2 x E2. Hence it paid a lower price when compared to the additional valuation it received from the market due to the increased earnings. (Mathematically, this can be represented by if P/E1 > P/E 2, then P/E 1(E1 + E2)> P/E1(E1) + P/E2(E2)) Hence the word accretive. A simple way to memorize this is: "Accrete is to add, add what?..value." So if I pay less and receive more value, it is accretive.

The reverse of this situation is a dilutive merger, and occurs when a company with a lower P/E ratio buys a firm with a higher P/E ratio. Here we use the term "buys" because the buying firm determines the final valuation multiple.

We'll look at a hypothetical example of a dilutive merger to make this clearer. Say Big Gun, a sporting goods store wants to buy a fast-growing chain called Ubershoe. Let's also say that Big Gun is valued at $500 million with earnings of $50 million, while Ubershoe is valued at $200 million with earnings of $10 million. Big Gun trades at a P/E ratio of 10/1; the combined company will also trade at this ratio. After the merger, the company will have earnings of $60 million, and will be valued at $600 million. This is a dilutive merger because previous to the deal, the combined valuation of the companies was $700 million.

Sample questions

1. Company A is considering acquiring Company B. Company A's P/E ratio is 55 times earnings, whereas

Company B's P/E ratio is 30 times earnings. After Company A acquires Company B, will Company A's earnings per share rise, fall, or stay the same?

Company A's earnings-per-share will rise, because of the following rule: when a higher P/E company buys a lower P/E company, the acquirer's earnings-per-share will rise. The deal is said to be "accretive," as opposed to "dilutive," to the acquirer's earnings.

2. Describe a recent M&A transaction that you've read about.

If you are preparing for an I-banking interview, this is a must prepare question. Read the papers and have at least one transaction thoroughly prepared. You should be able to cover various aspects of the transactions. You should know what the structure of the transaction was. Who was buying whom, or was it a merger of equals? Was it an all-stock ransaction or was there cash involved?

For example, you could talk about America Online's acquisition of Netscape. In that transaction, a stock swap valued at $4.2 billion, AOL acquired Netscape. You should talk about how the acquisition was structured from a financial point of view, and the effect the acquisition is likely to have on AOL's earnings (both long-term and short-term).

3. What were the reasons behind that transaction? Does this transaction make sense?

Perhaps more important than understanding the nuts and bolts mechanics of transactions is understanding the factors that drive M&A activity. The America Online/Netscape deal is especially interesting in this regard because it involves heavy strategic planning in a fast-moving industry (as opposed to, say, the merger between Mobil and Exxon, through which the two giants simply hope to consolidate, save, and boost profits).

America Online is a content-driven company with more than 14 million subscribers. Netscape has kick-ass software, in the form of a popular browser and tools for businesses to pursue e-commerce. However, Netscape has seen its browser market share fall as Microsoft, with its immense distribution strength (and questionable pairing of browser with operating system) has elbowed its way into the category. And despite America Online's undisputed lead in market share as an Internet service provider, it had not moved aggressively into what many consider to be the golden road of the Internet - e-commerce.

This deal partners AOL and Netscape with Sun Microsystems, which is a hardware company that boasts strong hardware products and sales and support staff. The partners envision a world in which companies use the e-commerce tools developed by Netscape, hawk their wares on America Online (lured by the audience AOL can deliver), and are supported in their hardware and service needs by Sun. Synergy for the 21st century.

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Matthew Williams:

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