FNCE20005 Corporate Financial Decision Making 2021

TUTORIAL 4: ISSUES with WACC and CAPITAL STRUCTURE POLICY
Answers to Section B questions to be submitted on Canvas by **10am on Monday, August 23rd**

SECTION A

Question 1
Distinguish between business risk, financial risk and default risk.

Question 2
Would you necessarily expect companies in the same industry to have similar debt–equity ratios? Give reasons for your answer.

Question 3
An executive of a mining company explains that it has a policy of maintaining a portfolio of projects at various stages of development. In this way the need for external finance is minimised because the cash flow generated by operating mines can be used to finance the development of new ones. Also the company's net cash flows can be smoothed by adjusting production plans to suit the timing of new projects. For example, if there are delays in bringing a new mine into production, the life of an old mine might be extended by mining low-grade ore that would not normally be considered economic. Critically evaluate the company's strategy from the viewpoint of shareholders.

Question 4
When evaluating a new project, management requires an estimate of the project's own cost of capital. The WACC formula only gives a cost of capital applicable to the company as a whole and is therefore inappropriate for this purpose. Comment on this statement.

SECTION B – Priority questions

REMEMBER ALSO THAT ALL ANSWERS MUST BE HANDWRITTEN AND YOUR NAME CLEARLY WRITTEN AT THE TOP OF EACH SUBMITTED PAGE.

Question 5

Critically evaluate the following statements:

a) It is obvious that companies should use as much debt as possible. It is cheaper than equity and the interest is tax deductible as well.

b) The probability of financial distress should be negligible for companies with a low proportion of debt. Therefore, a low proportion of debt should not have any noticeable effect on the cost of equity.

Question 6

In April 1997, Telstra, then a telecommunications company wholly owned by the Australian Government, announced a capital restructuring ahead of its proposed partial privatisation through a share market float during the second half of 1997. The capital restructuring involved payment of a special dividend of $3 billion to the government and the borrowing of $3 billion by Telstra. Its finance director reportedly said that 'the restructuring would lower the average cost of capital and enable greater financial flexibility'. Similarly, one journalist noted that 'debt financing is cheaper than equity raising'. His article also stated that 'debt interest payments are also tax deductible, while dividends are not'. Critically evaluate these comments on the effects of, and reasons for, the restructuring.

Question 7

Dorset Ltd is all-equity financed and has a cost of capital of 16 per cent per annum. An observer suggests that Dorset could easily borrow up to 40 per cent of the value of its assets at an interest rate of 10 per cent per annum and achieve a rating for its debt of A+ or better. He argues that replacing 40% of equity with debt would lower the company's cost of capital to 13.12%, and increase the net present value of some projects that were recently rejected.

Assuming an effective corporate tax rate of 12%, show how the observer arrived at a cost of capital of 13.12%. Is his argument correct? Give reasons for your answer.