Tutorial #:	4	Student Name:	James La Fontaine	Student ID:	1079860

Only answers to **Part B questions** are to be submitted by 10:00 am on Monday of the tutorial week. Please note the following:

1. Only **handwritten** work on this hand-in sheet will be marked for reasonable effort. You can either write your answers on this hand-in sheet or write your answers on a piece of paper with your name and student ID written on the top of the page.
2. Only **one** submission per student will be marked. Please make sure that you upload only one file either as a scanned **PDF file** or as a **JPG/PNG picture file**. Other formats will not be accepted by the system.
3. Please fill out all the information before submission.

5. a) While the cost of debt is lower than the cost of equity and the interest is tax-deductible, debt also increases the risk of financial distress and there are costs associated with bankruptcy. Debt also restricts what a company can do through covenants. The increase in financial risk a company takes on also increases the required rate of return by shareholders.

b) This is a true statement as the cost of equity is correlated with the amount of financial risk a company has. Therefore a low level of debt shouldn't have a noticeable effect on the cost of equity as there isn't a large level of financial risk which the company has to compensate shareholders for.

6. The average cost of capital will not necessarily lower as the required rate of return for shareholders will increase with the addition of debt and this debt will actually decrease financial flexibility as Telstra will have to spend part of their future cash flows on interest payments. Debt financing increases the cost of equity due to the increase in financial risk and isn't simply cheaper. Dividends are not tax-deductible but the tax advantage of debt is only relevant for investors from countries that use the classical tax system.

7. $WACC_{new} = k_d(1-t_c)\frac{D}{V} + k_e\frac{E}{V} = 0.10\times(1-0.12)\times 0.4 + 0.16\times 0.6$

$= 13.12\%$.

The observer's argument is not correct. This calculation assumes that the cost of equity will remain the same, but increasing debt results in the cost of equity increasing. Furthermore, WACC is only a suitable benchmark rate for projects with similar risk to the company's existing projects. The net present value of these projects increasing could be misleading and is a result of the WACC being incorrectly used to evaluate them.