

# **GESTÃO FINANCEIRA II**

## **PROBLEM SET 5: Solutions** Chapters 12, 14 and 15 Estimating the Cost of Capital Capital Structure in a Perfect World Debt and Corporate Taxes

**(FROM BERK AND DEMARZO'S "CORPORATE FINANCE")**

**LICENCIATURA – UNDERGRADUATE COURSE**

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## Chapter 12

### Estimating the Cost of Capital

**12-1. Suppose PepsiCo's stock has a beta of 0.57. If the risk-free rate is 3% and the expected return of the market portfolio is 8%, what is PepsiCo's equity cost of capital?**

$$3\% + 0.57 \times (8\% - 3\%) = 5.85\%$$

**12-14. In mid-2012, Ralston Purina had AA-rated, 10-year bonds outstanding with a yield to maturity of 2.05%.**

**a. What is the highest expected return these bonds could have?**

$$\text{Risk-free} \Rightarrow y = 2.05\%$$

**b. At the time, similar maturity Treasuries has a yield of 1.5%. Could these bonds actually have an expected return equal to your answer in part (a)?**

No.

**c. If you believe Ralston Purina's bonds have 0.5% chance of default per year, and that expected loss rate in the event of default is 60%, what is your estimate of the expected return for these bonds?**

$$y - d \times l = 2.05\% - 0.5\%(.60) = 1.75\%$$

**12-15. In mid-2009, Rite Aid had CCC-rated, 6-year bonds outstanding with a yield to maturity of 17.3%. At the time, similar maturity Treasuries had a yield of 3%. Suppose the market risk premium is 5% and you believe Rite Aid's bonds have a beta of 0.31. If the expected loss rate of these bonds in the event of default is 60%.**

**a. What annual probability of default would be consistent with the yield to maturity of these bonds in mid-2009?**

$$\begin{aligned} R_d &= 3\% + .31(5\%) = 4.55\% \\ &= y - pL = 17.3\% - p(.60) \\ p &= (17.3\% - 4.55\%) / .60 = 21.25\% \end{aligned}$$

**b. In mid-2012, Rite Aid's bonds has a yield of 8.3%, while similar maturity Treasuries had a yield of 1%. What probability of default would you estimate now?**

$$\begin{aligned} R_d &= 1\% + .31(5\%) = 2.55\% \\ y - pL &= 8.3\% - p(.60) = 2.55\% \\ p &= (8.3\% - 2.55\%) / .60 = 9.58\% \end{aligned}$$

## Chapter 14

### Capital Structure in a Perfect Market

**14-5. Suppose there are no taxes. Firm ABC has no debt, and firm XYZ has debt of \$5000 on which it pays interest of 10% each year. Both companies have identical projects that generate free cash flows of \$800 or \$1000 each year. After paying any interest on debt, both companies use all remaining free cash flows to pay dividends each year.**

- a. Fill in the table below showing the payments debt and equity holders of each firm will receive given each of the two possible levels of free cash flows.**

FCF	ABC		XYZ	
	Debt Payments	Equity Dividends	Debt Payments	Equity Dividends
\$800	0	800	500	300
\$1,000	0	1000	500	500

- b. Suppose you hold 10% of the equity of ABC. What is another portfolio you could hold that would provide the same cash flows?**

Unlevered Equity = Debt + Levered Equity. Buy 10% of XYZ debt and 10% of XYZ Equity, get  $50 + (30,50) = (80,100)$

- c. Suppose you hold 10% of the equity of XYZ. If you can borrow at 10%, what is an alternative strategy that would provide the same cash flows?**

Levered Equity = Unlevered Equity + Borrowing. Borrow \$500, buy 10% of ABC, receive  $(80,100) - 50 = (30, 50)$

**14-6. Suppose Alpha Industries and Omega Technology have identical assets that generate identical cash flows. Alpha Industries is an all-equity firm, with 10 million shares outstanding that trade for a price of \$22 per share. Omega Technology has 20 million shares outstanding as well as debt of \$60 million.**

- a. According to MM Proposition I, what is the stock price for Omega Technology?**

$V(\text{alpha}) = 10 \times 22 = 220\text{m} = V(\text{omega}) = D + E \Rightarrow E = 220 - 60 = 160\text{m} \Rightarrow p = \$8$  per share.

- b. Suppose Omega Technology stock currently trades for \$11 per share. What arbitrage opportunity is available? What assumptions are necessary to exploit this opportunity?**

Omega is overpriced. Sell 20 Omega, buy 10 alpha, and borrow 60. Initial =  $220 - 220 + 60 = 60$ . Assumes we can trade shares at current prices and that we can borrow at the same terms as Omega (or own Omega debt and can sell at same price).

**14-8. Schwartz Industry is an industrial company with 100 million shares outstanding and a market capitalization (equity value) of \$4 billion. It has \$2 billion of debt outstanding. Management have decided to delever the firm by issuing new equity to repay all outstanding debt.**

**a. How many new shares must the firm issue?**

Share price =  $4b/100m = \$40$ , Issue  $2b/40 = 50$  million shares

**b. Suppose you are a shareholder holding 100 shares, and you disagree with this decision. Assuming a perfect capital market, describe what you can do to undo the effect of this decision.**

You can undo the effect of the decision by borrowing to buy additional shares, in the same proportion as the firm's actions, thus relevering your own portfolio. In this case you should buy 50 new shares and borrow \$2000.

**14-12. Hardmon Enterprises is currently an all-equity firm with an expected return of 12%. It is considering a leveraged recapitalization in which it would borrow and repurchase existing shares.**

**a. Suppose Hardmon borrows to the point that its debt-equity ratio is 0.50. With this amount of debt, the debt cost of capital is 6%. What will the expected return of equity be after this transaction?**

$$r_e = r_u + d/e(r_u - r_d) = 12\% + 0.50(12\% - 6\%) = 15\%$$

**b. Suppose instead Hardmon borrows to the point that its debt-equity ratio is 1.50. With this amount of debt, Hardmon's debt will be much riskier. As a result, the debt cost of capital will be 8%. What will the expected return of equity be in this case?**

$$r_e = 12\% + 1.50(12\% - 8\%) = 18\%$$

**c. A senior manager argues that it is in the best interest of the shareholders to choose the capital structure that leads to the highest expected return for the stock. How would you respond to the argument?**

Returns are higher because risk is higher—the return fairly compensates for the risk. There is no free lunch.

**14-13. Suppose The Washington Post Company has no debt and an equity cost of capital of 9.2%. The average debt-to-value ratio for the publishing industry is 13%. What would its cost of equity be if it took on the average amount of debt for its industry at a cost of debt of 6%?**

At a cost of debt of 6%:

$$r_E = r_U + \frac{D}{E}(r_U - r_D)$$

$$r_E = 0.092 + \frac{0.13}{0.87}(0.092 - 0.06)$$

$$= 0.0968$$

$$= 9.68\%$$

**14-17. Mercer Corp. is an all-equity firm with 10 million shares outstanding and \$100 million worth of debt outstanding. Its current share price is \$75. Mercer's equity cost of capital is 8.5%. Mercer has just announced that it will issue \$350 million worth of debt. It will use the proceeds from this debt to pay off its existing debt, and use the remaining \$250 million to pay an immediate dividend. Assume perfect capital markets.**

- a. Estimate Mercer's share price just after the recapitalization is announced, but before the transaction occurs.

MM => no change, \$75

- b. Estimate Mercer's share price at the conclusion of the transaction. (*Hint: use the market value balance sheet.*)

Initial enterprise value =  $75 \times 10 + 100 = 850$  million

New debt = 350 million

$E = 850 - 350 = 500$

Share price =  $500/10 = \$50$

- c. Suppose Mercer's existing debt was risk-free with a 4.25% expected return, and its new debt is risky with a 5% expected return. Estimate Mercer's equity cost of capital after the transaction.

$R_u = (750/850) \times 8.5\% + (100/850) \times 4.25\% = 8\%$

$R_e = 8\% + 350/500(8\% - 5\%) = 10.1\%$

**14-18. In mid-2012, AOL Inc. had \$100 million in debt, total equity capitalization of \$3.1 billion, and an equity beta of 0.9 (as reported on Yahoo! Finance). Included in AOL's assets was \$1.5 billion in cash and risk-free securities. Assume that the risk-free rate of interest is 3% and the market risk premium is 4%.**

- a. What is AOL's enterprise value?  $3100 + 100 - 1500 = 1700$  million

- b. What is the beta of AOL's business assets?

Because the debt is risk free,  $\beta_u = \frac{E}{E+D} \beta_E = \frac{3100}{1700} (0.9) = 1.64$

- c. What is AOL's WACC?  $r_{WACC} = r_f + \beta_u (r_m - r_f) = 3\% + 1.64 \times 4\% = 9.56\%$

Alternatively,  $r_E = r_f + \beta_L (r_m - r_f) = 3\% + 0.9 \times 4\% = 6.6\%$

$$r_{WACC} = \frac{E}{D+E} r_E + \frac{D}{D+E} r_D = \frac{3100}{1700} 6.6\% - \frac{1400}{1700} 3\% = 9.56\%$$

## Chapter 15

### Debt and Corporate Taxes

15-5. Your firm currently has \$100 million in debt outstanding with a 10% interest rate. The terms of the loan require the firm to repay \$25 million of the balance each year. Suppose that the marginal corporate tax rate is 40%, and that the interest tax shields have the same risk as the loan. What is the present value of the interest tax shields from this debt?

Year	0	1	2	3	4	5
Debt	100	75	50	25	0	0
Interest		10	7.5	5	2.5	0
Tax Shield		4	3	2	1	0
PV	\$8.30					

15-10. Rogot Instruments makes fine violins and cellos. It has \$1 million in debt outstanding, equity valued at \$2 million, and pays corporate income tax at rate 35%. Its cost of equity is 12% and its cost of debt is 7%.

a. What is Rogot's pretax WACC?

$$r_{\text{wacc}} = \frac{E}{E+D} r_E + \frac{D}{E+D} r_D (1 - \tau_c) = \frac{2}{3} 12 + \frac{1}{3} 7 = 10.33\%$$

b. What is Rogot's (effective after-tax) WACC?

$$r_{\text{wacc}} = \frac{E}{E+D} r_E + \frac{D}{E+D} r_D (1 - \tau_c) = \frac{2}{3} 12 + \frac{1}{3} 7(.65) = 9.52\%$$

15-16. Milton Industries expects free cash flow of \$5 million each year. Milton's corporate tax rate is 35%, and its unlevered cost of capital is 15%. The firm also has outstanding debt of \$19.05 million, and it expects to maintain this level of debt permanently.

a. What is the value of Milton Industries without leverage?

$$V^U = \frac{5}{0.15} = \$33.33 \text{ million}$$

b. What is the value of Milton Industries with leverage?

$$V^L = V^U + \tau_c D = 33.33 + 0.35 \times 19.05 = \$40 \text{ million}$$

**15-18. Kurz Manufacturing is currently an all-equity firm with 20 million shares outstanding and a stock price of \$7.50 per share. Although investors currently expect Kurz to remain an all-equity firm, Kurz plans to announce that it will borrow \$50 million and use the funds to repurchase shares. Kurz will pay interest only on this debt, and it has no further plans to increase or decrease the amount of debt. Kurz is subject to a 40% corporate tax rate.**

- a. What is the market value of Kurz's existing assets before the announcement?**

$$\text{Assets} = \text{Equity} = \$7.50 \times 20 = \$150 \text{ million}$$

- b. What is the market value of Kurz's assets (including any tax shields) just after the debt is issued, but before the shares are repurchased?**

$$\text{Assets} = 150 \text{ (existing)} + 50 \text{ (cash)} + 40\% \times 50 \text{ (tax shield)} = \$220 \text{ million}$$

- c. What is Kurz's share price just before the share repurchase? How many shares will Kurz repurchase?**

$$E = \text{Assets} - \text{Debt} = 220 - 50 = \$170 \text{ million. Share price} = \frac{\$170 \text{ million}}{20} = \$8.50.$$

$$\text{Kurz will repurchase} \frac{50}{8.50} = 5.882 \text{ million shares.}$$

- d. What are Kurz's market value balance sheet and share price after the share repurchase?**

$$\text{Assets} = 150 \text{ (existing)} + 40\% \times 50 \text{ (tax shield)} = \$170 \text{ million}$$

$$\text{Debt} = \$50 \text{ million}$$

$$E = A - D = 170 - 50 = \$120 \text{ million}$$

$$\text{Share price} = \frac{\$120}{20 - 5.882} = \$8.50/\text{share}.$$