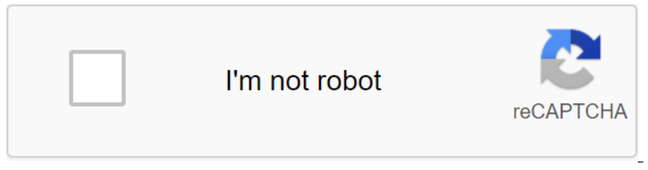

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Weighted average cost of capital questions and answers pdf

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Tufa Co's common shares have a face value of $0-50 per share, a market price of ex dividends of $7'07 per share and a market dividend price of $7-52 per share. Dividends for 20X7 will be paid soon. Dividends paid in recent years have been as follows: Year 20X6 20X5 20X4 20X3 Dividends ($/share) 0'43 0'41 0'39 0'37 5% preferred Tufa Co shares have a face value of $0'50 per share and an ex dividend market price of $0'31 per share. Tufa Co's long-term borrowing consists of $10 million in credit notes and a $3 million bank loan. 7% of credit notes have a face value of $100 for a credit note and a market price of $102 x 34 for a credit note. Annual interest has just been paid and credit notes can be repaid within four years at a rate of 5% premium to face value. Required: (a) Calculate the weighted average cost of Tufa Co's capital after tax based on market value. (11 marks) KPC Co. wants to raise $20 million in order to expand its business and would like to evaluate one possibility, which is the issue of 8% credit notes. Excerpts from THE CSK Co. financial statements are as follows. $m Income 140'0 Sales Cost and Other Expenses 112'0 Profit before interest and taxes 28'0 Financial Fees (interest) 2'8 Profit before tax 25'2 Taxation 7'6 Profit after tax 17'6 $m $m Share Financing Ordinary Shares ($2 1 nominal) 25'0 Reserves 118'5 143'5 Outside of Current Liabilities 36'0 Current Liabilities 38'3 Total Capital and Liabilities 217'8 It is expected that investing $20 million in the business will increase revenue by 5% during the first year. 40% of sales and other expenses are fixed, the rest are variable costs. Fixed costs will not be affected by business expansion, while variable costs will increase in line with income. CPC Co. pays corporate tax in 30%. The company has a policy of paying 40% of its after-tax profits as dividends to shareholders. Current liabilities are expected to increase by 3% by the end of the first year after the business expands. Averages of other companies similar to KPC Co: Debt/Equity Ratio (the basis of the book value): 30% Percentage Cap: 10 times Operating Transfer (contribution/PBIT): 2 times Return on Equity: 15% Required: (b) Discuss the circumstances in which the current weighted average value of a company's capital can be used in an investment valuation and briefly indicate how its limits as a discount rate can be overcome. You could see this issue fully worked out if you join classroomTinep Co's plans to raise funds to expand existing business activities and in preparation for this the company has decided to calculate its weighted average cost of capital. Tinep Co has the following capital structure: $m $m Common Equity 200 Reserves 650 850 Outside of Current Loan Liabilities Notes 200 1050 Ordinary Tinep Co shares have a face value of 50 cents per share and are currently traded on the stock market on an ex dividend basis of $5'85 per share. Tinep Co has a beta of 1/15 shares. Credit notes have a face value of $100 and are currently traded on the stock market on an ex-interest basis at $103 x 50 per credit note. Interest on credit notes is 6% per year before taxes and they will be repaid after six years with a premium of 6% to their face value. Without risk, the yield is 4% per year and the equity risk premium is 6% per year. Tinep Co pays corporate tax at a rate of 25% per annum. Required: (a) Calculate the market value of the weighted average value of capital and the weighted average cost of Tinep Co's capital, as well as briefly comment on any difference between the two values. (9 marks) AMH Co wants to calculate the current cost of capital for use as a discount rate in the investment valuation. The following financial information relates to AMH Co: Ordinary shares of AMH Co have an ex-div market value of $4.70 per share and a regular dividend of 36.3 cents per share has just been paid. Historic dividend payments were as follows: AMH Co's preferred shares cannot be repurchased and have a market value of ex div 40 cents per share. 7% of bonds are repurchased at a rate of 5% premium to their face value of $100 per bond and have a market value of $104-50 per bond. Bank credit has a variable interest rate, which averages 4% per year in recent years. AMH Co pays income tax at a rate of 30% per annum. Required: Calculate the market value of the weighted average cost of AMH Co. capital (12 marks) You could this issue is fully worked out if you join the classroomThe statement on the financial position of BKB Co provides the following following $m $m equity financing of common shares ($1 face value) 25 reserves 15 40 ---- outside current liabilities of 7% convertible bonds ($100 face value) 20 5% preferred shares ($1 face value) 10 30 ---- The current trading obligation of the payable 10 overdraft 15 25 ---- ---- total liabilities of 95 ---- BKB Co has a beta share of 1'2 and the ex-dividend market value of the company's capital is $125 million. and the market value of preferred ex-dividend shares is $6-25 million. BKB Co convertible bonds have a conversion rate of 19 common shares per bond. The conversion date and the buyback date are on the same date five years later. It is expected that for the foreseeable future the current price of BKB Co's common shares will increase by 4% per year. Overdraft has a variable interest rate, which currently stands at 6% per year, and BKB Co expects this to increase in the near future. The overdraft has not changed in the last financial year, although a year ago the overdraft interest rate was 4% a year ago. The company's bank will not allow the overdraft to increase at the current level. The equity risk premium is 5% per year, and without risk the yield is 4% per year. BKB Co pays income tax at a rate of 30% per annum. Required: (a) Calculate the market value after tax of the weighted average value of BKB Co's capital, clearly explaining any assumptions you make. (b) Discuss why the weighted average market value of capital is preferable to the weighted average value of capital when making investment decisions. Page 2 OF DVM can be with or without growth. This means that the share price can be calculated subject to dividend growth or not essentially this model assumes what the share price is. all future dividends. Calculate this (with or without growth) and multiply it by the total number of shares It is similar to market capitalization, except that it does not use the market share price, and one is designed using DVM This audio is placed on a service that uses the preferences of the tracing cookie. These cookies are currently disabled - to listen to this sound, you will need to give consent and re-incorporate the cookie settings in the CookieEnable settings all the stock price cookies calculated as: Permanent dividend/share price (decimal) share price will be provided, or calculated through CAPM Take this share price and multiply it by the number of shares Dividend per year 1 / Share value - rise (decimal) Or dividends just paid (1 g) / Share value - rise (decimal) Equity (50c) $2m dividend per share (just paid) 24c Dividends paid four years ago 15.25c Current market - 15% No Risk Rate 8% Beta Shares 0.8Dividend Grows So Use DVM With Growth Model: Growth Calculation Is Not Given So Should Calculate by by past dividends, As before: 24/15.25 sq m root to power 4 th 1.12 th 12% So dividends at the end of the year 1 and 24 x 1.12 Calculate the value of shares (using CAPM) 8 0.8 (15-8) % Share price 2 4x1.12 / 0.136 - 0.12 - 1,680c Market cap - $16.8 x (2m / 0.5) - $67.2 Page 3 So the more you hand out (in the form of dividends), the less you grow... Investment yield 12% Saved ratio 60% Growth will? g q r x b g 12% x 60% and 7.2% Of course the examiner could be Mr Annoying and give you a dividend payout ratio instead of... Return on investment - 10% Dividend Payout Ratio - 70% What is the growth? Well, if the payout ratio is 70%, so the saved ratio is 30% So, 10% x 30% and 3% Finally the examiner can be Captain Double Annoying and ask for dividends to be paid ... Cheeky monkey ROI - 10% Growth - 4% Profit - 100SO Saved ratio - 4/10 - 40%, So the dividend payout ratio is 60%, so the dividend is 60% x 100 and 60Page 4 This method also calculates the cost of equity (e.g. dvm), but more closely looks at shareholder returns, in terms of risk. The more risk a shareholder takes, the more profit he wants, so the share price will increase. For example, a shareholder looking for a new investment in another area of the business may have another risk. The model involves a well diversified (see later) investor. It suggests that any investor would at least want the same return return that they could get from risk-free investments such as government bonds (Greece?!!). This is called a risk-free return on top of the risk-free profits, they would also like to return to reflect the additional risk they take by investing in market share. They may want a yield higher or lower than the average market yield depending on whether the share they are investing in has a higher or lower risk, Than The Average Market Risk Average Market Premium Market Profit - Risk Free Profit The Higher or Lower Requirement Compared to the Average Market Premium Called Beta (β) Rm The Entire Market Rm - Rf - Average Market Risk Premium (β) - How Much Mid-Market Risk Premium (Rm - Rf) Needs More Beta Technically (β) - Systematic Risk Investment Compared to Market Risk although, do not have the same systematic risk as some of them suffer more or less than other external economic factors Not a systematic risk that is unique to a particular asset or company. An example of non-systemic risk is the possibility of low earnings or strike among employees of the company. You can reduce the non-systemic buying different securities in the same industry or different industries. For example, a particular oil company has a diversified risk that it may drill little or no oil in a given year. The investor can reduce this risk, risk, several different oil companies, as well as companies that have nothing to do with oil. Non-systemic risk is also called diversified risk. If you have one share and that share is doing badly, then you're not going to get it. If you have 10 shares and 1 share is doing badly, you are sad about 1 stock, but you are still HAPPY about the other 9. Therefore, with one action you take more risk than if you had more shares. This risk is called UNSYSTEMATIC RISK So we can buy more shares and therefore UNSYSTEMATIC RISK should get smaller you will always be left with some risk that cannot be diversified away. This risk is called SYSTEMATIC RISK. This beta (β) in the FORMULA CAPM Page 5 Is a beta investment If beta 1, the investments have the same risk as the market as a whole. If beta is 1, investments are riskier (more volatile) than the market, and investors should demand higher returns than market returns to offset additional risk. If beta is 1, investments are less risky than the market and investors will be satisfied with lower returns than market returns. No risk rate - 5% Market yield - 14% What yield should be required from investments, beta values of which: (i) 1 (ii) 2 (iii) 0.5 Share price - Rf s beta (Rm - Rf) (i) 5 - 1 (14 - 5) - 14% Yield required from investment with the same risk as the market, which is simply market yield. (ii) 5 and 2 (14 - 5) - 23% return on investments at twice the risk than the market. Therefore, a higher yield than the profitability provided by the market is required. (iii) 5 and 0.5 (14 - 5) - 9.5% return required from a half-risk investment in the market. Therefore, a lower yield than the market one is required. Diversified Investors Perfect Market (actually they are semi-strong at best) Risk-free returns are always available somewhere All investor expectations are the same relationship between risk and profitability in the market correctly looking at systematic risk only good for evaluating specific projects and working well in practice This involves a well diversified investor. Others, including managers and employees, may well want to learn about non-systemic risk, and the level of profit is seen only as important, not as the way it is given. For example, dividends and capital gains have different tax regimes that can be more or less beneficial for individuals. Some entrances are very hard to get. For example, the beta needs subjective analysis As typically, CAPM overstates the required return for high beta stocks and vice versa Page 6 Dividend Growth Model allows you to calculate the cost of equity using empirical values readily available to companies registered on Measure dividends, estimate their growth (usually based on historical growth) and measure market value share (although some caution is needed as the share price is often very volatile). Put these amounts into the formula and you have an estimate of the value of your equity. The current share price and dividends are easily known, but. it is very difficult to find an exact value for future dividend growth rates, using historical growth rates as a predictor of the future is not based on facts (next year's dividend/share price) - Growth may suggest that profitability will be reduced if the company has reduced its dividend or growth rate. It's not that. All that happens is that a reduction in dividends or a rate of dividend growth will result in a fall in the company's market value to the level at which investors receive the required yield. However... Finding suitable values for risk-free returns and beta stocks can be difficult to model dividend growth has a number of difficulties. For example, it is impractical to assume that future dividend growth rates are constant. The decision on dividends depends not only on past trends, but also on current conditions. The historical rate of dividend growth is used as a substitute for future dividend growth rates. The model also assumes that business risks and the cost of equity are permanent in future periods, but the reality shows us that companies are subject to constant changes. The dividend growth model does not view risk explicitly the same as CAPM. It is assumed that all investors will have diversified portfolios and as a result will seek only a return for the systematic risk of investment. Some components of CAPM are in empirical research, and therefore CAPM generates a much smaller degree of uncertainty than the one attached to future dividend growth rates in the dividend growth model. For this reason, CAPM is generally assumed to offer a better estimate of equity value than the dividend growth model. Model. weighted average cost of capital questions and answers pdf. weighted average cost of capital exam questions and answers

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