

# [Wrigleys jr company](https://assignbuster.com/wrigleys-jr-company/)

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This Report Investigates the financial effects on Wriggles with the issuance of $ban debt. It explores two alternate means of allocation for the funds; pay out a one-time dividend or carry out a share repurchase. Both methods are analyzed In regards to an optimal capital structure and maximizing share holder value (value of the firm). A compilation of historical data and future predictions were used for the basis of this report, and recommendations.

Literature Review The following paper will draw on Medallion and Miller’s (1958) theorem of capital Truckee to determine whether an ‘ optimal’ level for Wriggler’s can in fact be reached. A further discussion of agency costs and incentives by Jensen, Neckline (1976), and Leland (1998) will evaluate the relative impact of these risks on re-structuring.

Finally, Chambers, Harris and Pricing (1982) distinguish the approaches in valuation used for Wriggler’s. Optimal Capital Structure The Meadowland and Miller (1958) theorem has been widely touted as the basis for capital structure theory Propositions).

While previously rationalizing that a firm should be indifferent between various levels of financial leveraging – a further duty ‘ optimal’ level of capital structure which enhances the use of a tax shield to best offset the cost of debt. It is important to note however, that there are several implicit considerations ; limitations that are imposed with the increase of leverage (Medallion and Miller, 1963). Financial Distress ; Flexibility Financial distress and corporate performance Is a widely debated topic.

Although literature has portrayed financial distress as costly and Important In concluding on a firm’s optimal capital structure, People and Titian (1994) discovered that It Is substantially difficult to quantify.

While Wriggler’s has been given a BIBB rating, due in part to their interest coverage ratio of 1. 47; due to the fact that WAC has only increased 0. 01%, it can be assumed that financial distress would be relatively trivial. Incentive ; Agency Costs Another factor has been found by Jensen and Neckline (1976) to fall under consideration is that of agency costs.

They found the costs associated with a Value transfer’ to bondholders – although essentially unobservable – are offset to a much larger degree by the tax advantage gained by equity holders (Leland, 1998). Adjusted Present Value With the proposed restructuring at a set amount of $ban, APP Is used to measure the tax benefit associated with debt separately to that of the firm’s operations (Chambers, restructuring increases by an amount equal to that of the tax benefit: FL = V + Poof Tax benefits.

Once distributed between shareholders, reflects the following: Post- irreconcilability’s value I = Preachy. Equity value I Present value+ Debt tax shields I Present value oftentimes-relatedness I Signaling, incentive, & clientele effects | $61. 53 | = $56. 37 | + $5. 16/SSH I Insignificant I Unobservable I In terms of WAC – currently at 10.

90% – the effect of leveraging should (in theory) result in an overall reduction in the cost of capital thus optimizing both the value and structure of the firm (Medallion and Miller, 1963). However, WAC is seen to increase marginally by 0. 01%. This can be attributed to a possible insufficiency of the debt tax shield to offset the costs of interest payments, along with the levered beta of 0. 7 bearing higher systematic risk than that of the UN-levered beta at 0. 75.

Payoff With a dividend payout of $ban, the book value of total assets/capital will remain unchanged. However, common equity decreases by the debt amount, causing the book value per share to drop the exact dividend payout of $12. 91. Similarly, the market value of common equity sees a decline of $ban. Total capital on the other hand, sees an increase of $1.

Ban due to the tax shield; lowering the market value of equity and subsequently the value to public shareholders. In turn, the share price loses ground by $7. 4, sinking to levels of that of the S&P Food Beverage & Tobacco Index. In terms of share-repurchasing alternative, the market value and book-value of equity sees a proportionate drop. Due to the number of shares outstanding dropping from 232. 441 m to 183.

Mm\*, the book-value per share dramatically declines; whereas the share price increases by $5. 16 showing a spike in the WWW’ Index\*\*. Pre-capitalization PEPS was at 1. 61. However, due to the interest payments net income was lowered causing PEPS to drop considerably to 0. 48 from a running growing average.

Using the funds to repurchase shares also saw a drop in PEPS down to 0. 60 – higher than that of the dividend – due to the decrease in shares. From an BIT-PEPS reawaken analysis however, the repurchase method shows exponential growth as opposed to dividend. Voting Control From the two alternatives, only the option of share-repurchasing results in a change in Wriggles voting control. As such, following a re-purchase of 48. Mm shares, various approaches have shown a boost in Wriggles voting power from 46.

6% to a majority vote of above 51%. Summary The issuance of $ban debt to the Whom. WrigleyJar.

Company can be seen to cause a there are many implications that have been taken into consideration as to the viability and subsequent sustainability of the debt issue. The analysis has shown that by re-structuring, Wriggles as a company will be affected in several distinct ways.

In regards to cost of capital, WAC was seen to increase by 0. 01% which indicates the possible insufficiency of the debt shield to offset the cost of interest payments. This, along with an increased likelihood of financial distress, and the introduction of agency costs (brought about by a higher beta) has placed Wriggles with a non-investment grade rating of BIBB.

While these may seem detrimental in the short term, long term estimates point to an increased benefit. As debt is serviced into perpetuity, the continuous growth in earnings (with Wriggles being an established company within the market, operating in a low technology industry, and consistently sustainable growth) will greatly reduce the probability of financial distress and bankruptcy; moreover, incentive and agency costs would be largely offset by the interest tax shield. This will result in an improved credit rating and reduction in overall cost of capital until an ‘ optimal’ level is reached.

From the two alternatives given, an explicit preference is clear to see. With the evident alternative, the loss of share price value and dramatic decline in PEPS value will be likely to result in a negative market sentiment. Also, the provision of a large dividend payment is unsustainable to maintain. In respect to the alternative off re- purchase scheme, while the PEPS does show a considerable decline at first, long-term growth in earnings are seen to increase exponentially as the benefits of the tax shield reflects in a higher PEPS.

Value to shareholders increases through a rise in share price – upheld by $1.

Ban tax benefit into perpetuity; and value to Wriggles is achieved wrought acquiring the majority voting power. Recommendations: In relation to the ban debt restructuring, the recommendations are assuming that Wriggles has two options; Dividend or Repurchase. The Dividend option in comparison to the repurchase is not feasible as it places Wriggles in a less favorable position than that of the latter. In this case, value minimization out of the two options is better achieved through the repurchase method.

With financial policy objectives, a focal point is placed on maximizing shareholder value.

In respect to the $ban debt raising, it is evident that prerequisites are not adequately satisfied. Although the debt level can be achieved and maintained, the financial and operational strain shows that it’s not at an optimal debt to equity level.