Corporate finance solutions

Finance

a) LCM has been paying out regular quarterly dividends since 1990. It just slashed the dividend by half in the current quarter and a more severe cut is underway. LCM's stock price dropped from $43 to $39. 7 when the dividend cut was announced (GM just went through a similar story.) Explain the possible reasons for this drop. The stock price is the present value of all future dividend payments, if the expected future dividend payments drop, the stock price will also drop. Therefore, LCM's stock price dropped because of an expected drop in future dividend payments.

b) In spite of the theoretical arguments that dividend policy should be irrelevant, the fact remains that many investors like high dividends. If this preference exists, a firm can boost its share price by increasing its dividend-payout ratio. Explain the fallacy of this argument. If the market is in equilibrium, the number of investors who demand high dividend payment stocks should equal the number of such stocks available. The supplies and demands of each investor will be met in equilibrium. If the market is not in equilibrium, the number of high dividend payment stocks might be less than the demand. Only under such situation can a firm benefit from a policy changes.

c) In a world with no taxes, does dividend policy matter? Please explain. In a world with no taxes, dividend policy does not matter. The shareholder can effectively undo the firm's dividend strategy. If a shareholder receives a greater dividend than desired, he can reinvest the excess. On the other hand, if the shareholder receives a smaller dividend than desired, he can sell of extra shares of stock. The argument is due to MM and is similar to their homemade leverage concept.

d) Since debt financing is cheaper than equity financing, increasing the leverage of the firm always reduces the firm's weighted average cost of capital. TRUE or FALSE, and explain. The article directly suggests that investors want News Corp. to buy back (repurchase) shares because the share might be undervalued. However, you can also argue about a secondmotivation. Therefore, discuss the investors' push for the company to buy back stocks in light of the free cash flow hypothesis.

If a firm has positive NPV projects, it should invest its extramoneyon the positive NPV projects. Here the News Corp. investors might think acquisition is a negative NPV. Therefore, they are in favor of stocks repurchase since usually the immediate stock market reaction to the announcement of a stock repurchase is quite favorable, which will increase the stock price, therefore, benefit investors.

2. A group of private equity investors is examining different locations for a new plant to produce electronic equipments used in automobiles. Cleveland is one possibility. The city is attractive given that the automobile industry is already present in the area, and, as explained below, the incentives that the City is willing to provide for the new project. Let's call the new enterprise the Cleveland Project. The industry in which the Cleveland Project will operate is very competitive and consists mostly of young companies.

Most of them are privately owned, but there are two of them that are publicly traded: ElectPilot Inc. and Ganges Electronics. Exhibit I contains some information on these two companies. Moreover, some banks that have been advising the investors suggest that the peers in the industry (when you consider also the privately held firms) tend to follow a target capital structure such that B/S= 1/3.

Proforma (estimates) of the project's financial statements for the years 2008-2012 are shown in Exhibit II (numbers are shown in thousands of US$). There are no extra capital expenditures between 2008 and 2012. For simplicity, net working capital needs are excluded from the examination (their numbers are comparatively small). Beyond 2012, you can assume that unlevered cash flow will grow at the rate of 1% per year. The management has determined that the costs of building the new plant, building and equipment will amount to about $160, 000, 000.

Costs can be considered to be incurred in December 2007, and all flows in the financial statements can be considered year-end flows. Finally, your team of financial consultants provided you with the following information: the risk-free rate is 8%; the expected return on the market is 13%; the expected cost of debt at the target capital structure used by the industry is rB= 9%.