Mckenzie corporation capital budgeting

Finance

McKenzie Corporation Capital Budgeting McKenzie Corporation Capital Budgeting What is the expected value of the company in one year with and without expansion?

Expected value without expansion = 0. 3*25000000+0. 5*30000000+0. 2*48000000= 32. 1 million

Expected value with expansion = 0. 3*27000000+0. 5*37000000+0. 2*57- Cost of financing = 38-5. 7 million =$32. 3 million

Would the companys stockholders be better off with or without expansion and why?

- The company would be better off with the expansion because it would be yielding 0. 2 million more with = 32. 3 -32. 1= 0. 2 million

What is the expected value of the companys debt in one year, with and without expansion?

The company will not be giving out new debt in case the value of the firm increases above the face value. Consequently, the expected value of the company's debt will be the face value of $29 million because equity will be used to finance the expansion.

Implications:

In one year from the now, the value creation expected from expansion will require the calculation of the net value resulting from expansion.

Net value created from expansion = 32. 3 -32. 1= 0. 2 million

The result means that the stock holders should expect a value creation of 0. 2 million. However, for the bond holders they are not to expect anything since the case does not include them in valuation gain of the company.

From the above calculation, one can also deduce what will happen if the company does not expand. In case there is no expansion, the value of bonds will remain unchanged since it replicates the status of the bond holders which, as well remains unchanged.

Provided the expansion of the company occurs, the presence of net value created by expansion (0. 2 million), will boost equity leading to decrease in the debt to equity ratio. Intuitively, the company will also be experiencing reduction of the rate of return associated with its bonds. Decrease in the debt to equity ratio and rate of return will trigger increase in value of bonds and their price (Graham et al, 2010).

Further, from the calculations above one can also deduce what will happen to the company in case it does not expand; especially, the effects on future borrowing: Without expansion, the equity will remain the same as it is presently. In which case, the expiry of debt convenant next year implies that the company will not have greater equity needed to get financing (borrowing) to be used for expansion.

With expansion, the company secures enough equity to finance its expansion, as shown in 0. 2 million net value creation. This will trigger more equity next year, thanks to the expansion. Naturally, this places the company in a position where it is able to access more financing required for borrowing needs in the future.

The use of cash, rather than equity, in financing the expansion would have made it more productive and efficient because it relieves the company of the costs which may have been spent in changing equity into cash. The use of cash also means that the company would then avoid the time consuming procedure (changing equity to cash) (Graham et al, 2010). Consequently, the expansion would even look better when using cash than when using equity.

References

Graham, J. R., Smart, S. B., & Megginson, W. L. (2010). Corporate finance: [linking theory to what companies do]. Mason, OH: South-Western Cengage Learning.