

Optimal capital structure problems

Finance



Capital Structure Memo Irving Sharp, Chairman and CEO All Seasons Hotel.
Dennis Mark, CFO All Seasons Hotel. Date: 3rd December 2013 Subject:
Proposed Capital Structure It is important for “ All Season” to come up with a specific debt to equity ratio that will optimize the cost of capital of a company. This is the position at which the company’s value will be maximized. The fact that Cost of Capital has been always been shallow, the maximum debt/equity ratio can be defeated without raising the cost of capital. This will create a range in the lower portion of the graph where the cost of capital is similar throughout the range. There is certainty of getting off these ranges. The cost of capital will rise when it is off the range; this is illustrated by a blue line. The overall cost of capital for All Seasons is the cost of equity and the weighted Average. For instance “ All season” market value debt is 420 dollars, Market Value Equity is 180 dollars, the cost of debt is 14%, and equity beta is 1.36, while the marginal tax rate is 20%. Taking the company from its inception, “ All Season” was financed through equity; therefore, its average cost of capital was similar to the cost of equity. When the company grew, it attracted a track record and the confidence of lenders. When the company increased its debt use, it’s debt to equity ratio rose and the ACC dropped. Essentially, “ All Seasons” is undergoing substitution for cheaper debt with expensive equity, hence reducing its overall expenses. Eventually, as “ All Seasons debt/equity ratio rises, the cost of equity and cost of debt will rise. The lenders will be interested about the loan risk and the interest rate on the loan will increase. The shareholders will be concerned about the default able loan and will insist to receive higher return rate for the higher risk. Since equity and the cost of debt increases, the average cost of capital will equally rise. This will lead to the minimum point

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below the cost of capital curve. However, the curve for the majority of industries are normally shallow. Meaning the management team will have a considerable range in selecting the debt/equity ratio. The team will want to move at the base of the curve. Once the company will be there, it will maintain the position. However, there is debt/equity ratios range that will enable All Seasons to maintain the position below the curve. However, when the company goes outside the range, All Seasons will pay a lot of money to raise funds. This is because the company will be in a better position to borrow money and purchasing some of the costly equity. Conventionally, financing through debts is normally lower than equity finance. When the company moves to the curve's right hand, the company will pay a lot of money. This is because the stockholders and the lenders will perceive the company as no going-concern. The company should either issue new equity or pay the debt in the next financial year to lower the risk and move back to the shallow point of the curve. Therefore, the company value will be optimized if the finance department keeps the debt/equity ratio at the shallowest point of the curve. Additionally, the company will also finance its investments with the internal finances when possible and go for debt when the internal finances are exhausted. The company can also go for debt, retaining earnings, and selling new common stock. The new proposed capital structure will affect the firm's value. This is because of taxes, information asymmetry, and agency costs. The interest rate imposed on debt to buy securities will have an impact on the overall cost of debt. Other elements that will impact the cost of equity include the weighted cost of capital, which is used in calculating the company's return on capital, and that forms a major element that would affect the firm's value. With proper manipulation

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on the capital structure, “ All Season” will come up with the best debt mix, hybrid financing, and equity that will offer a maximum value of the company. Reference Moszoro, Marian, and Pawel Gasiorowski. Optimal capital structure of public-private joint ventures. Washington, D. C.: International Monetary Fund, Office of the Executive Director, 2008. Print.