

Working groups

[Business](#), [Work](#)



While the use of debt financing alone can be attractive in a number of ways, including higher-than-average return on investment, low costs, and adequate leverage-the continued use of debt could (1) greatly increase the costs of the sources of financing, (2) increases business risk, and, (3) because every company has a limited debt ratio, it could use up a portion of future capacity for borrowing. Issuing new common stock or preferred stock also has a number of advantages, but will probably not maximize shareholder value and continues to keep business risk high.

By combining more than one method of financing, a balance of business risk and financial risk can both be minimized. Therefore, I'm using the Weighted Average Cost of Capital (WACC). The WACC is the computed cost of capital determined by multiplying the cost of each item in the optimal capital structure by its weighted representation in the overall capital structure and summing up the results to discover the best methods of financing capital. This method helps to achieve a balance of business risk and financial risk. The after-tax cost of debt and the cost of common equity were both provided in the case.

In order to complete the numbers for the percent of debt and the percent of common equity to be used as a portion of financing the \$50, 000, 000 project, there are a number of ways to achieve this. One way to do this is to use a targeted capital structure. But CCI doesn't have a history of long-term debt and hasn't established a target for their capital structure yet. Another is to use a beta coefficient for the companies stock, which allows the use of the CAPM method and make other adjustments. Even though beta can be estimated by linear regression, or may be available from many brokerage

firms, etc., I do not have access to information that would provide an accurate beta coefficient for CCI.

Also, noting the tendency of the firm's earnings and cash flows can help to make a rough guess at what beta might be. If an accurate beta could be determined, which is still highly subjective, then we could adjust the financial leverage by plugging in the beta coefficient; thereby, accurately measuring both the business risk premium and the financial risk premium. The directors aren't really in agreement on what is best for everyone. Since the company doesn't have much experience in long-term debt, the directors are nervous about taking on debt.

Stocks are more familiar to them and some of the directors are arguing in favor of equity financing. Some are comfortable where they are—they don't like change— and would rather not allow newcomers to "steal" their little pot of gold for such bargain-basement prices. Only two of the directors felt that debt financing was the best option. One director thought that preferred stock was the way to go. Advantages: (1) Financing with debt will better balance their risk between business risk and financial risk. Right now, CCI has a lot of business risk—both internally and externally.

Small changes in management procedures could change profit and reduce stock value. A shift in economic conditions could have a similar affect. (2) CCI can become better leveraged with increased debt and could potentially make considerably more return on their investment. (3) CCI has a lot of assets. Even if they funded the full \$50, 000, 000 acquisition with debt, the debt ratio will only grow to 0. 40. (4) Also, CCI would benefit from an

additional \$2, 000, 000 tax shield and be able to return \$12, 700, 000 a year to its stockholders.

An added bonus to total debt financing, would be that EPS would increase to \$3. 87 compared to an equity-financed acquisition of \$2. 72 per share.

Disadvantages: (1) When a company's debt is too large, the financial risk increases and at some point will usually reduce stock value. (2) Debt alone can significantly increase financial risk. A large debt ratio could also result in a major business risk. Too much debt could considerably cripple a company in the event of an economic slow down. This is more of an external risk. (3) Debt holders claim profit before equity holders, so the chance that profits may be lower than expected, increases the financial risk to equity holders and may reduce stock value.

Disadvantages: (1) Continental's earning potential would be minimized without increased leverage. (2) CCI would not be able to take advantage of the full \$12, 700, 000 return on investment, but only about \$8, 900, 000. Reduced earning potential can also reduce the value of stock. (3) Internal risks from external sources should be considered before financing is acquired solely through new common stock. For example: Issuing 3, 000, 000 shares, which would represent 40% of the company's stock after the acquisition, presents the possibility of an outside firm, or even an extremely wealthy individual, purchasing all or a bulk of the newly issued shares.

Management could be forced out and/or lose controlling interest in the company. (4) Because of their low P/E ratio with respect to the rest of the market, and the replacement cost of the firm being greater than its book

value, there is a good chance that the current stock price and the proposed offering prices are too low. Long-term debt would be the better financing choice if the stockholders wanted to increase profits at a higher financial risk. Equity financing would be the better choice if the stockholders were comfortable with bringing on more "partners" to share in the minimal profits, but they are exposed to even greater business risk.

Both forms of financing the project have their advantages and disadvantages. By using the WACC model we can strike an optimal balance between risk and profit by using both debt and equity financing. Under the circumstances and given the concerns of the directors, I would recommend that they use both debt and equity financing. This recommendation will reduce some of the business risk and minimize the financial risk. The increased leverage will allow increased earnings while minimizing the inherent risk.