

The trade-off theory of capital structure

Finance



The Trade-Off Theory of Capital Structure

Question 1

A noncallable bond will fetch a high price than a callable bond as it is deemed more stable by an investor. On the other hand, callable bonds are more risky to the issuer and hence they must compensate the high risks with high coupon rate.

Question 2

Every bond is rated by at least a rating institution, and the rating gives investors critical information about a bond, its issuer and allows to make an informed decision when deciding whether to buy a bond or otherwise. These ratings have become a fundamental tools that investors rely on the appraising the quality of a bond. According to Pacific Daily news (2014), the recent GPA successfully sold \$76. 47 million of revenue bonds

Question 3

The trade-off theory of capital structure is the notion that a company decides on the level of debt finance and equity finance to be used in controlling the costs and benefits.

Question 4

The concept of dividend signaling asserts that the announcement of dividend payments by a company contributes positively to the future prospects of the company. The announcement of a rise in dividend payout helps to solidify the prospects in the market and improves the image of the company in lieu of growth prospects and stability in the future.

How much will a firm receive in net funding from a firm commitment underwriting of 250, 000 shares priced to the public at \$40 if a 10% underwriting spread has been added to the price paid by the underwriter?

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Additionally, the firm pays \$600, 000 in legal fees

$$250,000 \times 40 = 10,000,000$$

$$\text{Underwriting fee} = 0.1 \times 10,000,000$$

$$= 1,000,000$$

$$\text{Legal fees} + 600,000$$

$$1,600,000$$

The net amount the firm will receive will be $10,000,000 - 1,600,000$

$$= 8,400,000$$

Question 2

Shares 1 million \times \$23

Underwriter's spread \$1.90/share, and the total underwriter spread \$1.9 million

Legal and other fees \$1.65 million

Share price on the issue day \$27.50

According to Baker (2005), underwriter spread fall in the category of direct expenses whilst management fees such as legal fees fall with the indirect issuance expenses. Hence, \$1.9 million becomes the direct expenses and \$1.65 million become the indirect expense for the issuer.

The total costs of issuance becomes

Underwriting expenses 1,900,000

+ Legal fees 1,650,000

3,550,000

Percentage of the market value of the shares represented by the costs =
total costs/total value of shares

$$3,550,000 / 23,000,000$$

$$15.43\%$$

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Question 3

ABC outstanding shares 10, 000 sell at \$20

Operating income \$30, 000

Intent issue of \$50, 000 in 8% debt

Value of the firm

In economics, the value of the firm is linked to profit maximization; as a result the value of the firm is the present value of the firm's current and future profits. In finance to determine the present value of a firm, the present income is multiplied by five. Hence, the present value of ABC is operating income X5

$\$30,000 \times 5 = \$150,000.$

Earnings per Share (EPS) is calculated by subtracting dividends from preferred stock from net income and then dividing the result by the average outstanding shares

$EPS = \text{income} / \text{outstanding shares}$

$30,000 / 200,000$

$= 0.15$

Rate of return on the stock before restructuring

Rate of return on stock before restructuring = returns/ value of shares

$30,000 / 200,000$

$= 15\%$

Rate of return on the stock after restructuring

$30,000 / 250,000$

$= 12\%$

What changed?

The converted debt increased share holder value for the same rate of return,

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and hence mathematically if the value of a denominator increases in lieu of a constant numerator, then the result must be lower.

How investment in DEF will change if you currently own 100 shares valued at \$10 each and DEF has declared a 10% stock dividend? Before the stock dividend there were 2000 shares outstanding.

Total value of own shares at DEF = \$1000

A 10% dividend payout will imply a dividend income of \$100

Before dividend payout, DEF had 2000 shares outstanding

References

Baker, H. K., & Powell, G. E. (2005). *Understanding financial management: A practical guide*. Malden, MA: Blackwell Pub.

Pacific Daily news. (2014). UPDATE: GPA sells bond. Guampdn. com. 17th September 2014. <http://www.guampdn.com/article/20140918/NEWS01/140918003/UPDATE-GPA-sells-bond>