

Topic: finance – case 5 essay

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Topic: Finance – Case 51.

Introduction: This paper assumes that I am a senior financial manager, whose job is to recommend the best sources for this \$925 million capital requirement by Toyota Motor Corp. This will also specify the amount to be raised from each source, if any, and justify both my selection of each source as well as the amount I intend to raise from this source with due consideration of the issue of debt/equity balancing. 2.

Analysis and Discussion Option One – Source all the \$ 950 million from debt financing. Theoretically, using debt financing has two advantages. Brigham and Houston[1] (2002) enumerated the first advantage, as the deductibility of interest expense, while the second advantage, as those of debt-holders getting a fixed return, so shareholders do not share profits to said debt-holders if the business is extremely successful. The deductibility of interest expense means that the cost of incurring debt, that is the interest expense associated with incurring the debt is allowed to be deducted from taxable income as against the non-deductibility on dividends, which is the cost of raising capital from selling stock or raising through equity.

Does this mean that Toyota Motor Corp will now decide immediately to resort to finance the \$950 million via debt? The answer is not a categorical yes because there are also disadvantages for the use of debt financing. Brigham and Houston[2] gave the first one as that where the higher the debt ratio, the riskier the company; hence, the higher the cost of both debt and equity. The second disadvantage is a situation where a company falls on hard times and operating income is not sufficient to cover interest charges, and as

result, its stockholders will have to make the short fall, and if they cannot, bankruptcy will result. It cannot be said that the debt financing be resorted immediately for Toyota Motor Corp.

since the company may find itself in a very risky situation because of higher debt to equity or that the company may be operating on hard time and its operating income may not be sufficient to cover interest charges that may result in company's bankruptcy. Let us therefore investigate whether the debt to equity will be affected seriously if full debt financing is chosen. Case facts say that Toyota Motor Corp, the world's second largest automaker, has a big problem and that at the end of May 2006 the company had announced a recall affecting roughly one million of its vehicles worldwide. From this part of the case fact, it could be deduced that its financial problem must be felt earlier than May, 2006 announcement of the recall. For the purpose of this paper, we are using the financial position or balance sheet of Toyota Motor Corp. as of March 31, 2006 [3] as starting point to see the effect of financing the \$950 million. Based on these parameters, to raise the \$950 as pure debt will not make the company highly leveraged.

Please see Appendix A. We added the whole \$950 million to the March 31, 2006 balance of total liabilities and the resulting debt to equity ratio was 1.73 which has not almost changed debt to equity ratio[4] as of March 2006 at 1.72. By attempting to distribute the sourcing of the \$ 950 million with 50% from the debt and 50% from equity, the debt to equity is still at 1.72,

which has not much difference from the original debt to equity ratio as of March 31, 2006.

To verify further if present condition of the company is favorable for Toyota to adopt the debt financing, we found that for the years 2006, 2005 and 2004 the company has exhibited net profit margin of 0.07, 0.06 and 0.

07 respectively and return on equity of 0.13, 0.13 and 0.14 respectively.

See Appendix B. This means that the company has been earning well for the last three years and may indicate a favorable condition that the stockholders may just enjoy the rest of the profits by giving the debt-holders fixed amount of interest charges. Option Two – Source all the \$ 950 million from equity financing. Although preliminary analysis above would seem to indicate that debt financing is possible and more advantageous to the company, we will still lay down the merits of choosing pure equity as an option to finance needed capital.

If we are to go back to disadvantages of debt financing, we are reminded that the higher the debt ratio, the riskier the company and that if a company falls on hard times and operating income is not sufficient to cover interest charges, its stockholders will have to make the short fall, and if they cannot, bankruptcy will result[5]. By looking at it as a mirror image, it could be deduced that these disadvantages of debt financing, are also the implied advantages of equity financing. But since we have proven earlier that Toyota Motor Corp will not necessarily become too risky to invest due to the fact the debt to equity will not change much if the \$ 950million was purely borrowed, the implied advantage of equity financing does not apply.

In addition, the evidence of profitable performance of Toyota for the last three years destroys the second implied advantage of equity financing[6] over debt financing. Let us now try to analyze other theories which would support or discourage the use of equity financing. The choice of financing the \$950 million capital requirement could affect the so called optimum capital structure, which is the one that will maximize the value of stocks of the corporation. The issue that will be answered is whether resorting to pure equity financing will result to the higher price of stock to Toyota Motor Corporation. To answer this question, we will still see the relationship of the historical capital structure of the company for the last two years. By using a chart Yahoo Finance[7], the company has exhibited higher average in terms of prices of stock than Dow Jones and NASDAQ indices. The period covered is from June 2005 to June 2007, which when compared with capital structures as represented by debt to equity ratios for years 2005 and 2006 at 1.

0.69 and 1.72 respectively, it could be deduced that the company may have been operating at its optimum capital structure. Financing therefore the \$950 from pure equity may alter the apparently working-optimum capital structure for Toyota Motor Corp. As per analysis of the effects, however under option 2 in Appendix A, financing by pure equity would bring the debt to equity lower to 1.70 as against 1.73 when the financing is by pure debt. By looking at the graph from Yahoo Finance (2007) from the linked as given earlier, it would show that net advantage of prices of Toyota Motor Corp is higher for the year 2006 when the debt to equity was 1.72 than in 2005 when the debt to equity was 1.

69. This means that a 1.72 debt to equity ratio is nearer the optimum capital structure than 1.69, hence evidence would point that sourcing from debt financing the \$950 million is better than sourcing it from equity or stockholders. This decision to resort to borrowing as preferred than equity financing in the case of Toyota Motor Corp.

appears to be consistent also with the theory of the pecking order, which means that financing through equity should only be done as last resort.

[8]Conclusion and Recommendation We have seen in the case Toyota Motor Corp the application of finance theories where the general rule that debt financing is a better option under normal condition is applicable because the company at present is earning and can pay well the creditors that will extend the \$950 million debt. The result of the analysis by comparing the theory with required conditions for applying the principle confirmed that indeed debt financing is a cheaper alternative than equity financing. Since it came out from the analysis that making the source from pure debt as source did not affect the capital structure of the company, which seems to indicate the sign that the company is operating at optimum capital structure, choosing the option of debt financing is really a better option. It is thus recommended that the whole \$950 million should be financed purely by debt financing. The best measurement that was used to confirm the existence of the optimum capital structure is when the stock price of the company appeared higher in 2006 than in 2005 when the debt to equity was 1.

72. If resorting to pure debt that would give a debt to equity of 1.73, the option to choose pure debt financing is not too risky to choose still. Although apparently the \$950 million is not a big amount as against the company's size, in the nature of things and in accordance with the pecking order theory, equity financing should be only done as a last resort. Appendix A- Debt to Equity Computations under difference options, see excel file. Appendix B – Profitability ratios for the last three years of Toyota Motor Corp, see excel file. Work Cited: Brigham and Houston, Fundamentals of Financial Management, Thomson South-Western, USA, 2002 Graham, J. and Harvey, C.

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