An introduction to debt policy and value assignment

Business

Question 1: Does Borrowing Create Value? If so, for whom? If not, then why do so many executives concern themselves with leverage? It depends; Borrowing creates value if the company borrows at the optimal amount of debt or less. If the company borrows more than the optimal amount of debt, then borrowing will destroy value. Borrowing will increase value of the firm through the tax shield that borrowing brings. Thus, the increase value of the firm will increase the value of equity and create value to shareholders. draw: frame} {draw: frame} *If leverage affects value, then s*hould* it* cause changes in either the discount rate of the firm (i. e. , it's WACC) or the cash flows of the firm. Leverage affects value through the change in WACC not in the cash flows of the firm. WACC = (Wd (1-t) Kd) + (We * Ke). With change in leverage, Wd will change, which in return will change the WACC. Why does the value of assets change? Where, specifically, do the changes occur? The value of assets change due to the change in WACC.

Question 2: {draw: frame} {draw: frame} *As the firm levers up, how does the increase in value get apportioned between creditors and shareholders*? the increase in value gets apportioned based on the market value weights of Debt and Equity. For example, with 25% Debt and 75% Equity The market value weight of Debt = 23% The market value weight of Equity = 77% Value of Debt / Value of Debt +Equity = 2500 / 10849. 87 = 23% Value of Equity/ Value of Debt + Equity = 8349. 87 / 10849. 7 = 77% Question 3: {draw: frame} {draw: frame} Question 4: {draw: frame} {draw: frame} Question 5: Is leverage good for shareholders? Why? Is levering/unlevering the firm something shareholders can do for themselves? In what sense should shareholders pay a premium for levered companies? Yes, because it decreases WACC since the cost of debt decreases because of taxes. Since WACC decreases, the value of assets increases. Shareholders can change their return on equity by using homemade leverage which means that they purchase some of the stock on margin.

This means that shareholders can purchase stock in an unlevered firm and get the results of an identical levered firm. Shareholders should pay a premium for levered companies because the value of their assets tends to more, and also because the stock repurchase price is higher for a company with more leverage. Question 6: From a macroeconomic point of view, is society better off if firms use more than zero debt (up to some prudent point)? Yes, if firms use debt (up to a prudent point of course), the value of each particular firm will increase because of the decrease in WACC.

However, the increase in return to shareholders will also increase the risk of bankruptcy; but as long as the firm adheres to the best mixture of debt and equity, the advantages will remain more than the disadvantages. The individual economic prosperity of each shareholder will lead to a higher standard of living in the society as a whole. Also, if firms are of more value they would seek growth which could possibly lead to providing jobs and decreasing unemployment which is a factor of social stability. Question 7: {draw: frame} {draw: frame}