

# [Wrigley report](https://assignbuster.com/wrigley-report/)

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Due to the significance of the risk variable, two alternative calculation methodologies were employed to calculate the unlevered Beta; arithmetic and geometric. Once the unlevered Beta was found, it was re-levered to implement the new debt. ? L= ? U[1+1-tc? DE] 1. 1.

2 Distress Cost: 0. 87% (Appendix) The increase in debt financing increases the firms default risk. During periods of financial difficulty managements focus shifts from daily operating activities to consolidation strategies. This can diminish firm value and equity holders generally demand a risk premium to compensate for additional debt capital.

The debt premium introduced from the change in credit rating from AAA to BBB (outlined in 3. 2.

1) has been used as a proxy for the increase in default risk. 1. 1. 3 Agency Conflicts, Clientele and Signalling Effects Cost of Debt: 10. 45% 1.

1. 4 Standard and Poor’s Credit Rating Estimation: BBB To establish cost of debt, S; P corporate rating criteria was implemented. InitiallyWrigleyhad zero long term debt obligations. Applying the 7 S; P corporate ratings ratios Wrigley’s was AAA classed prior to capital restructuring.

The 5 ratios that exclude interest coverage were used initially to calculate a proxy cost of debt rating (BBB), to enable calculation of interest expense.

Once all ratios were calculated the mean rating was taken resulting in an A rating. This was rounded down to a BBB due to the approximation used in the initial calculation of interest expenditure. The rating was compared to corporate bond composite yield 31/03/2005 to establish cost of debt. Weighted Average Cost of Capital (WACC) \* Prior to Recapitalisation: 10. 80% \* Share Repurchase: 11.

41% \* Dividend Payout: 11. 7% WACC= KeEV+1-TcKdDV Initially as the firm is 100% equity financed and WACC is equal to the cost of equity. The alternative methods of capital restructure result in different D/E ratios for the firm (Appendix) this alters ? Lresulting in different WACC calculations as the equity value is not equal. Share Ratios Share Price \* Prior to Recapitalisation: $65. 57 \* Share Repurchase: $86.

69 \* Dividend Payout: $57. 03 The initial share price is the market price at 31/03/2005. The $3 Billion bond issue also lowered WACC through the tax shield benefit of $1. Billion these benefits were partially offset by distress costs. The share prices increases as a result of tax shield benefits less distress costs.

The share repurchase price is substantially higher due to the decrease in outstanding shares on issue. Dividend payout results in a lower share price due to the $3 Billion decline in equity. The underlying value to equity holders is equal in both scenarios. Earnings per Share \* Prior to Recapitalisation: $2. 29 \* Share Repurchase: $1. 79 \* Dividend Payout: $1.

46 EPS= Net IncomeOutstanding Shares

EPS represents the amount of income allocated to each share. In this instance the EPS is misleading, as net income does not vary between the repurchase and dividend payout. The difference in EPS can be attributed to the difference in the number of outstanding shares. Recommendation 1. 1 Company Objectives Level of Flexibility and Reserve Issuing bond is “ good news” to shareholders according to signalling (ref).

This is because the reason that the company can obtain a responsibility of carrying a debt instead of raising money from new shares.

Wrigley can prove the confidence to the investors that they are able to manage the liability. The other benefit of raising capital by bond is tax shields. Since the interest expense is deductible. Nevertheless, the volatility of interest rate needs to be taken into account for tax shield. Due to the fact that interest rate can be differ from year to year or even alter in a monthly basis.

Interest rate is rather low before the year of 2004 attributable to subprime mortgages. It starts to increase from 2004. This is delightful for Wrigley since there will be more tax shields benefits.

Conflict of interest is required to be concerned when a company attempt to issue bond in terms of agency cost. Managers of a corporate are more likely to conceive for the worth of stockholders.

In which the manager will undertake more risky project in order to increase rate of return. On the other hand, bondholders do not want their investment to default, so they prefer safer project. As a result, issuance of $3 billion bond is appropriate due to signalling and tax benefit as long as the interest of conflict can be solved.

However, Wrigley is in need to achieve an optimal mix of debt and equity in order to determine whether if it is suitable for current financial condition. In which will be examine in a further paragraph. The main objectives of the financial policy are to attain an optimal level of debt and equity, either to utilize the capital for dividend payout or repurchase the share and how much for the cash reserve.

Wrigley is solely equity based in previous. For this change in capital structure, it is essential to accomplish a ratio of debt and equity.