

Coke financial structure



Abstract The topic of this research paper will be about the capital structure of Coca Cola. This paper serves as a comparison of debt and equity. It will help determine the true value of the company while also determining what their free cash flow is and the risk level for the organization. The question that this research will try to answer is if the 125-year-old company is financially ready for another 125 years. The company needs to remain liquid and keep its operating costs low during times of inflation.

The methodology that will be used will be multiple financial ratios to determine how the organization is operating and compare to times of exponential increases in profits. My expected findings will be that Coca Cola will have a minimal amount of free cash flow. There would be enough to remain liquid but also to remain flexible in starting new product lines or new investments. Coca Cola already operates in over 200 countries and should seek to expand advertising efforts in recently adopted countries. I anticipate that the company has endured over 125 years of economical, political, and social upheavals. A preview of capital structure issues Capital structures of companies are based on the amount of debt and equity a company holds. When a company begins to increase its debt the company becomes more of a risk to investors because the company now has a higher chance that it may not be able to repay its debts. Although if there is more debt an organization taxes can be reduced because the organization is able to take out what it must pay as an interest to investors and holders from being taxed.

The higher cost of capital translates into a lower fair value estimate, and vice versa; furthermore, seemingly small changes in the cost of capital can make

a significant difference in a stock's fair value. The giant beverage maker, that's in a fairly stable environment does not have very much debt. The company in the non-alcoholic beverage industry, Coca Cola's cost of equity of 8.6% when the industry average is 11.67% and is a large influence on the WACC of 8.4%. Although the company incurs an 8.6% cost on equity the company has averaged a return on equity for the past five years of 30%. A Company with a high weighted average cost of capital could be considered a risky company or a company in a risky industry that mainly uses equity for funding. Coca Cola's debt to equity ratio is 23%, however, the total debt to equity has been on average for the past five years at 51% showing that the company uses only half debt to finance growth within the company which is accurate for a company that is not quite so capital intensive. Although the company finds itself in a well-established industry, it must still make investments and use 51% of debt to finance the new growth.

WACC and Free Cash Flow impact a company's value. FCF is what would come back to a company after the investment was made to enhance the company. FCF can determine if it is worth to take on an investment. Coca Cola's current Free Cash Flow. Business and financial risks related to capital structure There are many factors that could play into the financial risk of Coca Cola. The company itself, affiliates, subsidiaries, licensed distributors, and bottlers are a risk factor to Coca Cola. Bottlers generate a significant portion of Coke's net operating revenues by selling concentrates and syrups to independent bottling partners. In 2009, approximately 79 percent of our worldwide unit case volume was produced and distributed by bottling partners in which the Company did not have a controlling interest. The

company also operates internationally which is additional business and financial risk to the company. International economies and political environments become a risk to an American investor when considering purchasing securities.

Some business risk of the company includes the availability in Coca Cola's special ingredient of extracted coca leaf, the sustainment of a network that spans 200 countries, health concerns that cause a reduction in market demands. For the company to ensure that it has enough cash flows must be able to have the infrastructure to handle a large number of demands. Being that Coca Cola is an international company it has opened its doors to many more financial risks. Risks with their international counterparts include fluctuations in foreign currency and exchange rates affecting financial results. If interest rates rise or new tax laws are set it would negatively impact net income. An increase in costs due to shortages of supplies or materials to produce products or changes in accounting standards can all affect the risks of the company. Coca Cola monitors exposure to financial market risks using several objective measurement systems, including value-at-risk models. Value-at-risk calculations use a historical simulation model to estimate potential future losses in the fair value of our derivatives and other financial instruments that could occur as a result of adverse movements in foreign currency and interest rates.

Modigliani and Miller's capital structure theory. The underlying and basic assumption of the Modigliani and Miller Capital Structure Theory is that there is no major difference if a company were to fund its operations with the use of debt or using equity. The 1958 Modigliani-Miller Theorem was initially

designed to show that the corporation's capital structure decisions are not value increasing or decreasing; it has, however, become apparent that the theorem is far more general. The theory rests on assumptions that there are no brokers or bankruptcy costs, no taxes, and that investors can borrow at the same rate as the corporations and that EBIT is not affected by the use of debt. In 1991 Miller explained that the theory any gain from using more of what might seem to be cheaper debt is offset by the higher cost of now riskier equity and given a fixed amount of total capital, the allocation of capital between debt and equity is irrelevant because the weighted average of the two costs of capital to the firm is the same for all possible combinations of the two.

Criticisms of the MM model and assumptions The same assumptions that the Modigliani and Miller Capital Structure Theory is based on have been criticized. While the three Modigliani and Miller propositions make good sense and have become widely known there has been disagreement. Capital Structures that are designed to enhance value, the majority of the value is from the decisions that are made by financial managers. The value in the company is from the strategy that makes and it is the duty of the financial manager to make sure that the capital structure supports the strategy that the company is trying to pursue. Further, Coca Cola, initial strategy was to sell Ice cold Coca Cola's to its customers. The company was able to successfully change its strategy to only produce the syrup, the process was able to be broken down and both are able to reap values and benefits. By leaving capital structures to be independently determined by the bottlers and distributors, the structure of Coca Cola Holland and Coca Cola Japan to

be different. Other theories have been created in spite of the MM model such as the Trade-Off Theory which takes into consideration the costs of bankruptcy.

Capital structure evidence and implications Because of the low debt that Coca Cola has it also carries a low rate for taxes. In the last 5 years, half of Coke's worldwide investments include almost \$20 billion dollars in capital expenditures and acquisitions in the U. S. In addition, each year, we invest over \$10 billion dollars in our supply chain in the U. S. -- including \$208 million dollars that was spent this past year on supplies (Kent, 2010). In 2010, The Coca Cola Company acquired Coca Cola Enterprises (CCE) assets and liabilities. Coca Cola by purchasing CCE, Coke will have a \$100 million net pre-tax income benefit, however after adjusting to the impact of the full value of the stand-alone debt Coke will have acquired a \$200 million interest expense reduction. However, Coke stands to benefit from the overall transaction with a pre-tax benefit in 2011 of an estimated \$300 million (Investors Information, 2010). CCE is still set to acquire bottlers in Germany, Sweden, and Norway as part of the deal. With Coke becoming a producer and now a larger owner in bottling, this has changed the capital structure of the company.

Estimating the firm's optimal capital structure During the acquisition of Coca Cola Enterprises (CCE) assets and liabilities, Coca Cola's shares decreased while CCE increased. " With this transaction, we are converting passive capital into active capital, giving us direct control over our investment in North America to accelerate growth and drive long-term profitability Coke said, with the transactions that are expected to generate operational cost

savings of approximately \$350 million over four years for Coca-Cola and will add to earnings by 2012. The current estimate of Coke's cost of debt is 7% as well as the WACC. If this amount were to increase it is possible that it could also increase the risk to investors. Coke's beta has been reported at .59 and for the non-alcoholic beverage industry is average. With its current capital structure, Coke has had a steady 6% in revenue growth. The company also recently acquired CCE their debts, liabilities as well as CCE's acquisitions which is why Coke's shares declined by 3. These changes were brought about due to economical conditions and felt the need to take over more operations. Although this acquisition affected their shares in the short term, the company has estimated that this change will save the company almost \$350 million in operational costs in four years and will begin generating income by 2012.

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