Exercise Set: Capital Structure

Loyal Sea

Loyal Sea Inc. is a company with a D/E of 1. Currently shareholders expect a return of 12%, whilst debt has a cost of 5%. The tax rate is 25%. Assume the firm wants to maintain a constant D/E. What is the WACC of this company?

1) What is the WACC of the same company if it changes its D/E to 0?
2) What would be the cost of equity of the same company if it changed its D/E to 3?

Manuel & Manuel

Manuel & Manuel, SRL is a company currently with a debt-to-equity ratio of 0.25. Shareholders currently require a return of 12% and the cost of debt is 5%. The corporate tax rate is 20%. Assume the firm wants to maintain a constant D/E. What is the current WACC of this company?"

3) What would be the WACC of this company if it changed its debt-to-equity ratio to zero?
4) What would be the WACC of this company if it changed its debt-to-equity ratio to 0.4?

Theoretical questions

5) Which of the following sentences regarding taxes is false?
   a. Interest tax shield exists because interest is recognized as an expense in the income statement
   b. The fact that companies pay taxes favors the increase of financial leverage of companies, in general
   c. The value of a company increases if there is a higher tax rate
   d. The potential of tax shield increases if there is more debt
   e. Interest tax shield in real business world has a limited value because profits of companies are limited