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#Diego Butler

so many fake sites. this is the first one which worked! Many thanks

Sample Problems for WACC

Question 1:

Suppose a company uses only debt and internal equity to finance its capital budget and uses CAPM to compute its cost of equity. Company estimates that its WACC is 12%. The capital structure is 75% debt and 25% internal equity. Before tax cost of debt is 12.5 % and tax rate is 20%. Risk free rate is $r_{RF} = 6\%$ and market risk premium $(r_m - r_{RF}) = 8\%$. What is the beta of the company?

Answer:

$$\begin{aligned} WACC &= w_d r_d (1-T) + w_c r_c \\ 0.12 &= 0.75(0.125)(1-0.20) + 0.25 r_c \\ 0.12 &= 0.075 + 0.25 r_c \\ r_c &= 18\% \end{aligned}$$

$$\begin{aligned} r_c &= 18\% = r_{RF} + \beta(r_m - r_{RF}) \\ 18\% &= 6\% + \beta(8\%) \\ \beta &= 1.5 \end{aligned}$$

Question 2

A company finances its operations with 50 percent debt and 50 percent equity. Its net income is $I = \$30$ million and it has a dividend payout ratio of $x = 20\%$. Its capital budget is $B = \$40$ million this year.

The interest rate on company's debt is $r_d = 10\%$ and the company's tax rate is $T = 40\%$.

The company's common stock trades at $P_0 = \$66$ per share, and its current dividend of $D_0 = \$4$ per share is expected to grow at a constant rate of $g = 10\%$ a year.

The flotation cost of external equity, F issued, is $F = 5\%$ of the dollar amount issued.

a) Will the company have to issue external equity?

$$\begin{aligned} w_c R &= 0.50(\$M) = \$20M \\ I(1-x) &= \$30(1-0.2) = \$24M \end{aligned}$$

Since $I(1-x) > w_c B \Longrightarrow$ Internal Equity

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