

STUDY GUIDELINES FIN3701 - STUDY UNIT 7

1 GENERAL

This study unit is covered in chapter 12 of the prescribed textbook. This study unit is a combination and continuation of study unit 5 and 6. The process of choosing the capital structure weights used in study unit 5 (to calculate the WACC) will now be discussed in detail. The WACC will also be used to calculate the total value of the company and to choose the optimal capital structure. The study unit also focuses on the effect of introducing long-term debt on the EPS (will be calculated the same way as in study unit 6) and the total value of the company.

2 FORMAT OF ASSESSMENT

The content of this study unit will be assessed by means of multiple choice questions. No formulae will be provided in the examination and students will not be required to draw graphs for this study unit.

3 IMPORTANT AREAS IN THE STUDY UNIT

Pay attention to the following:

- The most important formulae:
 - The value of the firm formula (textbook page 511, equation 12.11).
 - The value of the firm formula (textbook page 516, equation 12.12).
 - The weighted average cost of capital (WACC) formula (textbook page 463, equation 11.9).
 - The expected EPS formula (textbook page 214, equation 5.2).
 - The standard deviation formula (textbook page 214, equation 5.3).
 - The coefficient of variation formula (textbook page 216, equation 5.4).

4 Study Guide Errata

Areas to correct:

Page 83: Example of capital structure decision

Insert an extra row below on the second table.

Coefficient of variation of EPS	Estimated required rate of return (k_r)
0.43	15%
0.47	16%
0.51	17%
0.56	18%
0.64	24%

Page 84: Solution to the example of capital structure decision

Question 1

Own capital for the 60% debt structure should be R100,000.

The number of shares should be in units. Students must remove the "R" for all debt structures.

Debt ratio	0%	20%	40%	60%
Own capital				R100,000
Debt				
Number of shares	25,000	20,000	15,000	10,000

Areas to skip:

Page 73: The optimal capital structure and the value of the firm

Skip the four different approaches to the theory of capital structure.

Page 74 - 80: The optimal capital structure and the value of the firm

Skip from the statement: "Given the assumptions, the company is concerned with the following three rates" (page 74) up to figure 7.3 (page 80).

Page 81: EBIT-EPS Analysis

Skip the equation given before the Vihela Security company example.

$$\frac{(E\text{DBIT} - I)(1 - t) - PD}{S_1} = \frac{(E\text{BIT} - I)(1 - t) - PD}{S_2}$$

Where t = tax rate

PD = preference share dividends

S1 and S2 = number of ordinary shares outstanding after financing for plan 1 and 2

Page 82: EBIT-EPS Analysis

Skip the whole page.