

Financial Management

Chapter 4. Capital Structure

Case on Financial Leverage

Our company has made the following sales forecasts for the coming year, considering three possible scenarios, with the odds associated in parentheses:

Sales Scenario (units of products).

Pessimist (20%)	40,000
Neutral (50%)	60,000
Optimistic (30%)	100,000

The unit price of sale is 10€. In the current situation the amount of fixed costs is € 80,000 per year and variable costs are 3€ per product unit.

Regarding the financial situation, the company has no debt and the capital stock is represented by 500,000 shares that are quoted at 6€. The tax rate is 30%.

The board of directors is analyzing to modify our capital structure in order to include some debt in our financial mix. This would be done through a 600,000€ loan of with a maturity of 20 years at 10% interest rate. The proceeds of the loan would be used to repurchase our own shares. Loan amortization system: annual interest payment and payment of principal at the maturity.

Questions:

1. What would be the effects of the proposed change on capital structure on earnings per share (eps) and on the volatility of eps?
2. What conclusions can you draw about the effects of capital structure on shareholder's wealth?