The Cost of Capital

1. Bankston Corporation forecasts that if all of its existing financial policies are followed, its proposed capital budget would be so large that it would have to issue new common stock. Since new stock has a higher cost than retained earnings, Bankston would like to avoid issuing new stock. Which of the following actions would REDUCE its need to issue new common stock?

a. Increase the dividend payout ratio for the upcoming year.
b. Increase the percentage of debt in the target capital structure.
c. Increase the proposed capital budget.
d. Reduce the amount of short-term bank debt in order to increase the current ratio.
e. Reduce the percentage of debt in the target capital structure.

2. LaPango Inc. estimates that its average-risk projects have a WACC of 10%, its below-average risk projects have a WACC of 8%, and its above-average risk projects have a WACC of 12%. Which of the following projects (A, B, and C) should the company accept?

a. Project B, which is of below-average risk and has a return of 8.5%.
b. Project C, which is of above-average risk and has a return of 11%.
c. Project A, which is of average risk and has a return of 9%.
d. None of the projects should be accepted.
e. All of the projects should be accepted.

3. Which of the following statements is CORRECT?

a. When calculating the cost of preferred stock, a company needs to adjust for taxes, because preferred stock dividends are deductible by the paying corporation.
b. All else equal, an increase in a company's stock price will increase its marginal cost of retained earnings, rs.
c. All else equal, an increase in a company's stock price will increase its marginal cost of new common equity, re.
d. Since the money is readily available, the after-tax cost of retained earnings is usually much lower than the after-tax cost of debt.
e. If a company's tax rate increases but the YTM on its noncallable bonds remains the same, the after-tax cost of its debt will fall.

4. Which of the following statements is CORRECT?

a. Since debt capital can cause a company to go bankrupt but equity capital cannot, debt is riskier than equity, and thus the after-tax cost of debt is always greater than the cost of equity.
b. The tax-adjusted cost of debt is always greater than the interest rate on debt, provided the company does in fact pay taxes.
c. If a company assigns the same cost of capital to all of its projects regardless of each project's risk, then the company is likely to reject some safe projects that it actually should accept and to accept some risky projects that it should reject.
d. Because no flotation costs are required to obtain capital as retained earnings, the cost of retained earnings is generally lower than the after-tax cost of debt.
e. Higher flotation costs tend to reduce the cost of equity capital.

5. Cranberry Corp. has two divisions of equal size: a computer manufacturing division and a data processing division. Its CFO believes that stand-alone data processor companies typically have a WACC of 8%, while stand-alone computer manufacturers typically have a 12% WACC. He also believes that the data processing and manufacturing divisions have the same risk as their typical peers. Consequently, he estimates that the composite, or corporate, WACC is 10%. A consultant has suggested using an 8% hurdle rate for the data processing division and a 12% hurdle rate for the manufacturing division. However, the CFO disagrees, and he has assigned a 10% WACC to all projects in both divisions. Which of the following statements is CORRECT?

a. While the decision to use just one WACC will result in its accepting more projects in the manufacturing division and fewer projects in its data processing division than if it followed the consultant's recommendation, this should not affect the firm's intrinsic value.
b. The decision not to adjust for risk means, in effect, that it is favoring the data processing division. Therefore, that division is likely to become a larger part of the consolidated company over time.
c. The decision not to adjust for risk means that the company will accept too many projects in the manufacturing division and too few in the data processing division. This will lead to a reduction in the firm's intrinsic value over time.
d. The decision not to risk-adjust means that the company will accept too many projects in the data processing business and too few projects in the manufacturing business. This will lead to a reduction in its intrinsic value over time.
e. The decision not to risk adjust means that the company will accept too many projects in the manufacturing business and too few projects in the data processing business. This may affect the firm's capital structure but it will not affect its intrinsic value.