**Exam level question**

The finance director of Kingsize plc is currently reviewing the capital structure of her company. She is convinced that the company is not financing itself in a way that minimises its cost of capital (WACC). The company’s financing as at 1 January 20X2 is as follows:

£000 Ordinary shares, £1 each 15,000

Reserves 10,000

7% preference shares, £1 each 10,000

10% bonds (redeemable after 7 years) 15,000

 50,000

Other information (as at 1 January 20X2):

 Ordinary share price (ex-div) £2.65

Preference share price (ex-div) 75p

Bond price for 10% bonds £102

Last 5 years’ dividends (most recent last) 22p, 23p, 25p, 27p, 29p

The finance director feels that by issuing more debt the company will be able to reduce its cost of capital. She proposes the issue of £15m of 11 per cent bonds. These bonds will be sold at a 5 per cent premium to their par value and will mature after seven years. The funds raised will be used to repurchase ordinary shares which the company will then cancel. She expects the repurchase will cause the company’s share price to rise to £2.78 and the future dividend growth rate to increase by 20 per cent (in relative terms). She expects the price of the 10 per cent bonds to be unaffected, but the price of the preference shares to fall to 68p. Corporate tax stands at 19 per cent.

(a) Calculate the *current* cost of capital (WACC) for Kingsize plc.

(b) Given the proposed changes to Kingsize’s capital structure*, recalculate* the company’s cost of capital to reflect these changes and comment on the finance director’s projections.

(c) Identify and discuss possible inaccuracies that may occur with the finance director’s estimates.