Question – capital structure

1. Eastwell is to be established shortly as a partnership. The founders are considering their options with regard to capital structure. A total of £1m will be needed to establish the business and the 3 ways of raising those funds are:
2. Selling 500,000 shares at £2.00
3. Selling 300,000 shares at £2.00 and borrowing £400,000 with an interest rate of 12%
4. Selling 100,000 shares at £2.00 and borrowing £800,000 at an interest rate of 13%

There are 3 possible outcomes for the future annual cash flows before interest:

*Poor success of product £60,000, probability 0.25*

*Good success of product £160,000, probability 0.50*

*Excellent success of product £300,000 probability 0.25*

Required:

* Calculate the annual expected return to shareholders under each capital structure
* Calculate the standard deviation of the expected annual return under each capital structure
* Explain and calculate the business and financial risk under each structure
* Interpret this information using traditional theory of capital structure.
* How does this contrast with Modigliani and Miller?