**Final Test Question (04/03/2021)**

You can either solve this question on a piece of paper, or in Excel. Please submit detailed workings via my courses.

**Capital Structure**

The Finance Director of **Kosmos plc** is currently reviewing the capital structure of the company. She is convinced that the company is too reliant on equity financing and thinks that the cost of capital figure (WACC) is therefore disproportionately high. The company’s balance sheet as at 1 January 2021 is as follows:

|  |  |
| --- | --- |
|  | £000 |
| Ordinary shares, £1 each | 15,000 |
| Reserves | 10,000 |
| 8% bonds (redeemable after 6 years at £100 par) | 5,000 |
|  | 30,000 |
| Other information (as at 1 January 2021): |  |
| Ordinary share price (ex-div) | £2.5 |
| Market price for 8% bonds | £106 |
| Corporate tax | 22% |

Last 5 years’ dividends (most recent last) 20p, 22p, 15p, 28p, 38p

1. Calculate the *current* cost of capital (WACC) for **Kosmos plc**.

**(5 marks)**

**Additional Information:**

The finance director thinks that by borrowing more, the company will be able to reduce its relatively high cost of capital. She proposes to take a substantial bank loan of £15m. Financial advisors believe that the bank will charge interest equivalent to the annual borrowing rate between 31.12.2023 and 01.01.2024 determined by the strips data presented below:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Strips at par £100** |  |  |  |  |  |  |
| Maturity at year end | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 |
| Current market prices (£) | 98 | 95 | 93 | 90 | 85 | 80 |

*Please turn over*

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 £3.2 and the future dividend growth rate to increase to 16% per cent. The finance director expects the price of the originally issued 8 per cent bonds to be unaffected.

1. Given the proposed changes to **Kosmos’s** capital structure*, recalculate* the company’s cost of capital. **(5 marks)**
2. Discuss theoretical concepts that describe the relationship between debt to equity ratio and the effect on the WACC. Relate your discussion to the results obtained in (a) and (b). **(5 marks)**

**TOTAL 15 MARKS**