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Sample Problems for WACC

Question 1:
Suppose a company uses only debt and internal equity to finance its capital budget and uses CAPM to compute its cost of equity. Company estimates that its WACC is 12%. The capital structure is 75% debt and 25% internal equity. Before tax cost of debt is 12.5 % and tax rate is 20%. Risk free rate is $r_{RF} = 4\%$ and market risk premium $(r_M - r_{RF}) = 6\%$. What is the beta of the company?

Answer:
$$WACC = w_D r_D (1 - \tau_c) + w_E r_E$$
$$12 = 0.75(12.5)(1 - 0.20) + 0.25r_E$$
$$12 = 0.675 + 0.25r_E$$
$$r_E = 19\%$$
$$r_E = 19\% = r_{RF} + \beta(r_M - r_{RF})$$
$$19\% = 4\% + \beta(6\%)$$
$$\beta = 1.3$$

Question 2
A company finances its operations with 50 percent debt and 50 percent equity. Its net income is $J = \$10$ million and it has a dividend payout ratio of $w = 20\%$. Its capital budget is $I = \$8$ million this year.
The interest rate on company's debt is $r_D = 10\%$ and the company's tax rate is $\tau_c = 40\%$.
The company's common stock trades at $P_0 = \$60$ per share, and its current dividend of $D_0 = \$4$ per share is expected to grow at a constant rate of $g = 10\%$ a year.
The flotation cost of external equity, if issued, is $F = 2\%$ of the dollar amount raised.
a) What the company have to issue external equity?
$$w_D r_D = 0.50(10\%) = 5\%$$
$$r(E - I) = 8(1) - (2) = 24M$$

Show $(E - I) > w_D I$ --- Internal Equity