GB550: Financial Management | Unit 5

Details and Rubric

This assignment is assessing learning outcome:

GB550-4: Assess the impact of a firm's financing decisions on its capital structure and shareholder distribution policy.

Moore Plumbing Supply Company

Capital Structure

Mort Moore founded Moore Plumbing Supply after returning from duty in the South Pacific during World War II. Before joining the armed forces, he had worked for a locally owned plumbing company and wanted to continue with that type of work once the war effort was over. Shortly after returning to his hometown of Minneapolis, Minnesota, he became aware of an unprecedented construction boom. Returning soldiers needed new housing as they started families and readjusted to civilian life. Mort felt that he could make more money by providing plumbing supplies to contractors rather than performing the labor, and he decided to open a plumbing supply company. Mort's parents died when he was young and was raised by his older brother, Stan, who ran a successful shoe business during the 1920s. Stan often shared stories about owning his own business and in particular about a large expansion that was completed just before the market collapsed. Because of the economic times, Stan lost the business but was lucky to find employment with the railroad. He dutifully saved part of each paycheck and was so thankful that his brother returned home safely that he decided to use his sizable savings to help his brother open his business. Mort kept in mind his brother's failed business and vowed that his company would operate in such a way that it would minimize its vulnerability of general business downturns.

Moore's extensive inventory and reasonable prices made the company the primary supplier of the major commercial builders in the area. In addition, Mort developed a loyal customer base among the home repair person, as his previous background allowed him to provide excellent advice about specific projects and to solve unique problems. As a result, his business prospered and over the past 20 years, sales have grown faster than the industry. Because of the large orders, the company receives favorable prices from suppliers, allowing Moore Plumbing Supply to remain competitive with the discount houses that have sprung up in the area. Over the years, Mort has kept his pledge and the company has remained a very strong financial position. It had a public sale of stock and additional stock offers to fund expansions including regional supply outlets in Milwaukee, Wisconsin, and Sioux City, Iowa.

Recently, Stan decided that the winters were too long and he wanted to spend the coldest months playing golf in Florida. He retired from the day-to-day operations but retained the position of President and brought in his grandson, Tom Moore, to run the company as the new Chief Executive Officer. Tom was an excellent choice for the position. After graduating summa-cum-laud with a degree in communications from the University of Wisconsin, he worked in the Milwaukee operation where he was quickly promoted to manager. In ten years, sales quadrupled under his leadership and employees remained loyal. He was familiar with the supply and demand of various components and was able to spot new trends in the industry before they became widely accepted. Although he had developed a keen sense of financing working capital, he had no background in higher-level corporate finance decision-making.

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Tom spent the first few months on the new job trying to get a better handle on the bigger picture and puzzled over the company's historical balance sheets, income statements, and cash flow statements. One area that concerned him was the company's heavy reliance on equity financing. Moore Plumbing has a large line of credit and uses this and short-term debt to finance its temporary working capital requirements. However, it does not use any permanent debt capital. Other construction related retail and wholesale companies have between 30 and 40 percent of their long-term capitalization in debt. Tom wonders why other companies use more permanent debt and what affect adding long-term debt would have on the company's earnings and stock price.

Tom met with the company's vice president of finance, Walt Harriman, and learned that the company projected its earnings before interest and taxes to be $12 million for the next year with projected tax rate to be 40 percent. Tom next talked to the company's investment bankers and discovered that the company's cost of equity was 16 percent. Since the company did not use debt or preferred stock financing, this also represented the company's current weighted average cost of capital. The investment bankers indicated that the company could issue at least $30 million of long-term debt at a cost of 9 percent. The company bonds would be highly rated and would carry a low coupon because the company easily service the debt.

Because of Stan's depression experience and his early involvement in funding the initial operation, the company not only avoided debt but also followed a policy of paying out most of its earnings as dividends, Stan was frequently quoted saying "a company with a high dividend policy rarely declared bankruptcy." In lieu of using retained earnings to reinvest in the company, the company used accounts payable and deferred taxes to meet its operating capital needs and issued capital was purchased by members of the Moore family and they currently hold 75 percent of the outstanding equity.

Tom is interested in gaining additional insights into capital structure issues and has asked Walt to brief him in the area. He wants a basic review of the terminology but is particularly interested in the impact of different types of risk and in understanding of the better-known financial theorists. Walt knew that Tom could grasp complex issues quickly and felt that a thorough discussion of Modigliani and Miller's work would be appropriate. He also felt that Miller's addition of personal taxes to the earlier models would be good to cover, and he determined that a good approximation of personal tax rate on debt income was 28 percent and for stock income was 20 percent. He decided to add the more recent considerations of financial distress, agency costs, and information asymmetry for a comprehensive overview. To help with this analysis, Walt developed the following estimates for cost of debt and cost of equity that included an increasing premium for financial distress and agency costs as the debt ratio increases.

Debt ratio	**kd**	**ks**
0%	----	16.0%
10%	9.00%	17.0%
20%	9.25%	17.8%
30%	9.75%	19.0%
40%	10.50%	20.5%
50%	12.00%	22.0%
60%	15.00%	26.0%
70%	20.00%	30.0%

80%	30.00%	40.0%
90%	50.00%	60.0%

You have been assigned to help Walt develop the **briefing** and he has prepared the following questions to help direct your energies. He has also asked you to think about **other relevant issues that Moore might bring up.** Walt is aware of Tom's keen intellect but is also aware of his reputation for "asking the right questions" and for having little tolerance for people who are not adequately prepared so, he is concerned about covering the issues in an understandable manner.

Questions

1. What is meant by capitalization? What is meant by a firm's capital structure? For financial planning purposes, explain why either book or market value should be used to determine the firm's capital structure. What is capital structure theory?

2. Discuss the following issues relating to business risk and financial risk.

    a. What is the difference between business risk and financial risk? Explain some of the factors that contribute to each. Evaluate Moore Plumbing Supply's level of business risk.
    b. How do these risks relate to total risk?
    c. How does business risk affect capital structure decisions?

3. Discuss the following issues relating to Modigliani and Miller's (MM) 1958 capital structure model.
    a. What was the importance of the model?
    b. What are the basic assumptions of the model?

4. Discuss MM's later models (1963) in which they relaxed the no-tax assumption and added corporate taxes. Discuss Proposition I and II. Miller added personal taxes to the model in his 1976 Presidential Address to the American Finance Association. What happens to Miller's model, in general, if there are no corporate or personal taxes? What happens when only corporate taxes exist?

5. Briefly describe the asymmetric information theory of capital structure. What are its implications for financial managers?

6. Prepare a summary of the implications of capital structure theory that can be presented to Tom Moore. What insights can capital structure theory provide managers regarding the factors that influence their firm's optimal capital structures?

7. Finally, what recommendations would you make about the capital structure of Moore Plumbing Supply Company? Justify your answer.

Prepare this Assignment as a Word® document. List each question, followed by your answer.

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Once completed, submit your Assignment to the Unit 5 Assignment Dropbox. The Assignment is due Tuesday 11:59 p.m. ET of their assigned unit.