

# STUDY SESSION

# 10

## Corporate Issuers (2)

**T**his study session begins with practical techniques to estimate a company's, or project's, cost of capital, a key input used in both corporate decision-making and investor analysis. Methods to estimate the costs of the various sources of capital are covered. Next, capital structure considerations and the Modigliani-Miller propositions are discussed, including factors affecting the use of leverage by companies. Examples of potential stakeholder conflicts that arise with financing decisions are also examined. The session concludes with coverage of the various types of leverage (operating, financial, total), measures of leverage, and the impact that leverage may have on a company's earnings and financial ratios.

### READING ASSIGNMENTS

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|-------------------|--|
| <b>Reading 30</b> | Cost of Capital-Foundational Topics<br>by Yves Courtois, CMT, MRICS, CFA, Gene C. Lai, PhD,<br>and Pamela Peterson Drake, PhD, CFA                             |
| <b>Reading 31</b> | Capital Structure<br>Raj Aggarwal, PhD, CFA, Glen D. Campbell, MBA, Pamela<br>Peterson Drake, PhD, CFA, Adam Kobor, PhD, CFA, and<br>Gregory Noronha, PhD, CFA |
| <b>Reading 32</b> | Measures of Leverage<br>by Pamela Peterson Drake, PhD, CFA, Raj Aggarwal, PhD,<br>CFA, Cynthia Harrington, CFA, and Adam Kobor, PhD,<br>CFA                    |

**LEARNING OUTCOMES****READING 30. COST OF CAPITAL-FOUNDATIONAL TOPICS**

The candidate should be able to:

- a** calculate and interpret the weighted average cost of capital (WACC) of a company;
- b** describe how taxes affect the cost of capital from different capital sources;
- c** calculate and interpret the cost of debt capital using the yield-to-maturity approach and the debt-rating approach;
- d** calculate and interpret the cost of noncallable, nonconvertible preferred stock;
- e** calculate and interpret the cost of equity capital using the capital asset pricing model approach and the bond yield plus risk premium approach;
- f** explain and demonstrate beta estimation for public companies, thinly traded public companies, and nonpublic companies;
- g** explain and demonstrate the correct treatment of flotation costs.

**READING 31. CAPITAL STRUCTURE**

The candidate should be able to:

- a** describe how a company's capital structure may change over its life cycle;
- b** explain the Modigliani–Miller propositions regarding capital structure;
- c** describe the use of target capital structure in estimating WACC, and calculate and interpret target capital structure weights;
- d** explain factors affecting capital structure decisions;
- e** describe competing stakeholder interests in capital structure decisions.

**READING 32. MEASURES OF LEVERAGE**

The candidate should be able to:

- a** define and explain leverage, business risk, sales risk, operating risk, and financial risk and classify a risk;
- b** calculate and interpret the degree of operating leverage, the degree of financial leverage, and the degree of total leverage;
- c** analyze the effect of financial leverage on a company's net income and return on equity;
- d** calculate the breakeven quantity of sales and determine the company's net income at various sales levels;
- e** calculate and interpret the operating breakeven quantity of sales.