Name of Student

Name of Professor

Name of Class

Day Month Year

Questions and problems

**1.**
**a.**

Given target capital structure

Common stock = 70

Preferred stock = 5%

Debt = 25% 35%

Cost of equity = 11 %

Cost of preferred stock = 5 %
Pretax cost of debt = 7 %

Relevant tax rate = 35 %

Mullineaux’s WACC =?

**Solution:**

**WACC Formula = (E/V \* Re) + (D/V) \* Rd \* (1 – Tax rate)**

By putting values,

WACC = .70(.11) + .05(.05) + .25(.07) (1 – .35)

 WACC = 0.077 + .0025+0.011375

 = 9.08%

**b.**

Company uses debt more as compared to preferred stock as debt is tax deductible while dividends are not. After-tax cost of debt makes the use of debt cheap as compared to the preferred stock. Here, it is

Rd = 0.07(1 – .35)

By putting values,

= 0.07\* 0.65

 = 4.55%

 **2.**

There are different types of industries given in the observed Capital Structures. Electric utilities, computer equipment, paper, petroleum refining, airlines, pay television, motor vehicles, Fabric apparel, department stores, eating places, drugs and steel works. There is change in the average debt-equity ratios with the change in the industry type. Specific types of industries are more likely to be highly leveraged than others such as capital intensive industries; petroleum refining, airlines, steel works, pay television and motor vehicles. Some sectors that have uncertain future earnings such as computer equipment and drugs use less financial leverage. Moreover, there is also a role of operating results and tax history of the firms in this decision. All these affect the future earnings prospects of the industries or companies.