GETTING TO THE OPTIMAL FINANCING MIX

The pathway to the optimal mix can be rocky.
Now that we have an optimal.. And an actual..
What next?

- At the end of the analysis of financing mix (using whatever tool or tools you choose to use), you can come to one of three conclusions:
  - The firm has the right financing mix
  - It has too little debt (it is under levered)
  - It has too much debt (it is over levered)

- The next step in the process is
  - Deciding how much quickly or gradually the firm should move to its optimal
  - Assuming that it does, how should it move to its optimal, i.e., a recapitalization or investments.
A Framework for Getting to the Optimal Debt Ratio

Is the actual debt ratio greater than or lesser than the optimal debt ratio?

Actual > Optimal
Overlevered

Is the firm under bankruptcy threat?

Yes
Reduce Debt quickly
1. Equity for Debt swap
2. Sell Assets; use cash to pay off debt
3. Renegotiate with lenders

No
Does the firm have good projects?
ROE > Cost of Equity
ROC > Cost of Capital

Yes
Take good projects with new equity or with retained earnings.

No
1. Pay off debt with retained earnings.
2. Reduce or eliminate dividends
3. Issue new equity and pay off debt.

Actual < Optimal
Underlevered

Is the firm a takeover target?

Yes
Increase leverage quickly
1. Debt/Equity swaps
2. Borrow money & buy shares.

No
Does the firm have good projects?
ROE > Cost of Equity
ROC > Cost of Capital

Yes
Take good projects with debt.

No
Do your stockholders like dividends?

Yes
Pay Dividends

No
Buy back stock
Disney: Applying the Framework

Is the actual debt ratio greater than or lesser than the optimal debt ratio?

- **Actual > Optimal**
  - Overlevered

  Is the firm under bankruptcy threat?
  - Yes
    - Reduce Debt quickly
      1. Equity for Debt swap
      2. Sell Assets; use cash to pay off debt
      3. Renegotiate with lenders

    Yes
    - Take good projects with new equity or with retained earnings.

  - No
    - Does the firm have good projects?
      - Yes
        - ROE > Cost of Equity
        - ROC > Cost of Capital

      Yes
      - Take good projects with new equity.

    No
    - No
      - 1. Pay off debt with retained earnings.
      - 2. Reduce or eliminate dividends.
      - 3. Issue new equity and pay off debt.

  - Actual < Optimal
    - Actual (11.5%) < Optimal (40%)

  Is the firm a takeover target?
  - Yes
    - No. Large mkt cap & positive Jensen’s α

  - No
    - Increase leverage quickly
      1. Debt/Equity swaps
      2. Borrow money & buy shares.

    Does the firm have good projects?
    - Yes
      - ROE > Cost of Equity
      - ROC > Cost of Capital

      Yes
      - Take good projects With debt.

    No
    - 1. Pay off debt with retained earnings.
    - 2. Reduce or eliminate dividends.
    - 3. Issue new equity and pay off debt.

    Do your stockholders like dividends?
    - Yes
      - Pay Dividends
    - No
      - Buy back stock
Application Test: Getting to the Optimal

Based upon your analysis of both the firm’s capital structure and investment record, what path would you map out for the firm?

a. Immediate change in leverage
b. Gradual change in leverage
c. No change in leverage

Would you recommend that the firm change its financing mix by

a. Paying off debt/Buying back equity
b. Take projects with equity/debt
Task
If your firm’s actual debt ratio is different from its optimal, evaluate how quickly it has to act & what the best course of action is.