Finding the Right Financing Mix: The Capital Structure Decision

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First Principles

- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.

- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.

- If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.
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?
        - Yes
          - Take good projects with new equity or with retained earnings.
        - No
          - Take good projects with 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?
        - Yes
          - Take good projects with debt.
        - No
          - Do your stockholders like dividends?
            - Yes
              - Pay Dividends
            - No
              - Buy back stock

Aswath Damodaran
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

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

Pay Dividends
Designing Debt

**Start with the Cash Flows on Assets/Projects**

- **Duration**
- **Currency**
- **Effect of Inflation Uncertainty about Future**
- **Growth Patterns**
- **Cyclical & Other Effects**

**Define Debt Characteristics**

- **Duration/Maturity**
- **Currency Mix**
- **Fixed vs. Floating Rate**
  - More floating rate
  - If CF move with inflation
  - With greater uncertainty on future
- **Straight versus Convertible**
  - Convertible if cash flows low now but high exp. growth
- **Special Features on Debt**
  - Options to make cash flows on debt match cash flows on assets

**Overlay Tax Preferences**

- **Deductibility of cash flows for tax purposes**
- **Differences in tax rates across different locales**
  - If tax advantages are large enough, you might override results of previous step

**Consider Ratings Agency & Analyst Concerns**

- **Analyst Concerns**
  - Effect on EPS
  - Value relative to comparables
- **Ratings Agency**
  - Effect on Ratios
  - Ratios relative to comparables
- **Regulatory Concerns**
  - Measures used

**Factor in Agency Conflicts between Stock and Bond Holders**

- **Observability of Cash Flows by Lenders**
  - Less observable cash flows lead to more conflicts
- **Type of Assets Financed**
  - Tangible and liquid assets create less agency problems
- **Existing Debt Covenants**
  - Restrictions on Financing

**Consider Information Asymmetries**

- **Uncertainty about Future Cashflows**
  - When there is more uncertainty, it may be better to use short term debt
- **Credibility & Quality of the Firm**
  - Firms with credibility problems will issue more short term debt

**Can Securities be designed that can make these different entities happy?**

- **Zero Coupons**
- **Commodity Bonds**
- **Catastrophe Notes**
- **Operating Leases**
- **MIPs**
- **Surplus Notes**
- **Convertibles**
- **Puttable Bonds**
- **Rating Sensitive Notes**
- **LYONs**

**Design debt to have cash flows that match up to cash flows on the assets financed**
Approaches for evaluating Asset Cash Flows

I. Intuitive Approach
- Are the projects typically long term or short term? What is the cash flow pattern on projects?
- How much growth potential does the firm have relative to current projects?
- How cyclical are the cash flows? What specific factors determine the cash flows on projects?

II. Project Cash Flow Approach
- Project cash flows on a typical project for the firm
- Do scenario analyses on these cash flows, based upon different macroeconomic scenarios

III. Historical Data
- Operating Cash Flows
- Firm Value
Coming up with the financing details: Intuitive Approach

<table>
<thead>
<tr>
<th>Business</th>
<th>Project Cash Flow Characteristics</th>
<th>Type of Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creative Content</td>
<td>Projects are likely to</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td>1. be short term</td>
<td>1. short term</td>
</tr>
<tr>
<td></td>
<td>2. have cash outflows are primarily in dollars (but cash inflows could have a substantial foreign currency component)</td>
<td>2. primarily dollar</td>
</tr>
<tr>
<td></td>
<td>3. have net cash flows which are heavily driven by whether the movie or T.V series is a “hit”</td>
<td>3. if possible, tied to the success of movies.</td>
</tr>
<tr>
<td>Retailing</td>
<td>Projects are likely to</td>
<td>Debt should be in the form of operating leases.</td>
</tr>
<tr>
<td></td>
<td>1. medium term (tied to store life)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2. primarily in dollars (most in US still)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>3. cyclical</td>
<td></td>
</tr>
<tr>
<td>Broadcasting</td>
<td>Projects are likely to</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td>1. short term</td>
<td>1. short term</td>
</tr>
<tr>
<td></td>
<td>2. primarily in dollars, though foreign component is growing</td>
<td>2. primarily dollar debt</td>
</tr>
<tr>
<td></td>
<td>3. driven by advertising revenues and show success</td>
<td>3. if possible, linked to network ratings.</td>
</tr>
</tbody>
</table>
# Financing Details: Other Divisions

<table>
<thead>
<tr>
<th>Theme Parks</th>
<th>Projects are likely to be</th>
<th>Debt should be</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1. very long term</td>
<td>1. long term</td>
</tr>
<tr>
<td></td>
<td>2. primarily in dollars, but a significant proportion of revenues come from foreign tourists.</td>
<td>2. mix of currencies, based upon tourist make up.</td>
</tr>
<tr>
<td></td>
<td>3. affected by success of movie and broadcasting divisions.</td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td>Projects are likely to be</td>
<td>Debt should be</td>
</tr>
<tr>
<td></td>
<td>1. long term</td>
<td>1. long term</td>
</tr>
<tr>
<td></td>
<td>2. primarily in dollars.</td>
<td>2. dollars</td>
</tr>
<tr>
<td></td>
<td>3. affected by real estate values in the area</td>
<td>3. real-estate linked (Mortgage Bonds)</td>
</tr>
</tbody>
</table>
II. QUANTITATIVE APPROACH

1. Operating Cash Flows
   - The question of how sensitive a firm’s asset cash flows are to a variety of factors, such as interest rates, inflation, currency rates and the economy, can be directly tested by regressing changes in the operating income against changes in these variables.
   - Change in Operating Income(t) = a + b \times \text{Change in Macro Economic Variable}(t)
   - This analysis is useful in determining the coupon/interest payment structure of the debt.

2. Firm Value
   - The firm value is clearly a function of the level of operating income, but it also incorporates other factors such as expected growth & cost of capital.
   - The firm value analysis is useful in determining the overall structure of the debt, particularly maturity.
## The Historical Data

<table>
<thead>
<tr>
<th>Year</th>
<th>Firm Value</th>
<th>% Change</th>
<th>Operating Income</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>$ 1,707</td>
<td></td>
<td>$</td>
<td>119.35</td>
</tr>
<tr>
<td>1982</td>
<td>$ 2,108</td>
<td>23.46%</td>
<td>$ 141.39</td>
<td>18.46%</td>
</tr>
<tr>
<td>1983</td>
<td>$ 1,817</td>
<td>-13.82%</td>
<td>$ 133.87</td>
<td>-5.32%</td>
</tr>
<tr>
<td>1984</td>
<td>$ 2,024</td>
<td>11.4%</td>
<td>$ 142.60</td>
<td>6.5%</td>
</tr>
<tr>
<td>1985</td>
<td>$ 3,655</td>
<td>80.6%</td>
<td>$ 205.60</td>
<td>44.2%</td>
</tr>
<tr>
<td>1986</td>
<td>$ 5,631</td>
<td>54.1%</td>
<td>$ 280.58</td>
<td>36.5%</td>
</tr>
<tr>
<td>1987</td>
<td>$ 8,371</td>
<td>48.7%</td>
<td>$ 707.00</td>
<td>152.0%</td>
</tr>
<tr>
<td>1988</td>
<td>$ 9,195</td>
<td>9.8%</td>
<td>$ 789.00</td>
<td>11.6%</td>
</tr>
<tr>
<td>1989</td>
<td>$ 16,015</td>
<td>74.2%</td>
<td>$ 1,109.00</td>
<td>40.6%</td>
</tr>
<tr>
<td>1990</td>
<td>$ 14,963</td>
<td>-6.6%</td>
<td>$ 1,287.00</td>
<td>16.1%</td>
</tr>
<tr>
<td>1991</td>
<td>$ 17,122</td>
<td>14.4%</td>
<td>$ 1,004.00</td>
<td>-22.0%</td>
</tr>
<tr>
<td>1992</td>
<td>$ 24,771</td>
<td>44.7%</td>
<td>$ 1,287.00</td>
<td>28.2%</td>
</tr>
<tr>
<td>1993</td>
<td>$ 25,212</td>
<td>1.8%</td>
<td>$ 1,560.00</td>
<td>21.2%</td>
</tr>
<tr>
<td>1994</td>
<td>$ 26,506</td>
<td>5.1%</td>
<td>$ 1,804.00</td>
<td>15.6%</td>
</tr>
<tr>
<td>1995</td>
<td>$ 33,858</td>
<td>27.7%</td>
<td>$ 2,262.00</td>
<td>25.4%</td>
</tr>
<tr>
<td>1996</td>
<td>$ 39,561</td>
<td>16.8%</td>
<td>$ 3,024.00</td>
<td>33.7%</td>
</tr>
</tbody>
</table>
The Macroeconomic Data

<table>
<thead>
<tr>
<th>Long Bond Rate</th>
<th>Change in Interest</th>
<th>Real GNP</th>
<th>GNP Growth</th>
<th>Weighted Dollar</th>
<th>Change in Dollar</th>
<th>Inflation Rate</th>
<th>Change in Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>13.98%</td>
<td></td>
<td>3854</td>
<td>-1.6%</td>
<td>115.65</td>
<td>6.48%</td>
<td>8.90%</td>
<td>-5.10%</td>
</tr>
<tr>
<td>10.47%</td>
<td>-3.51%</td>
<td>3792</td>
<td>-1.6%</td>
<td>123.14</td>
<td>6.48%</td>
<td>3.80%</td>
<td>-5.10%</td>
</tr>
<tr>
<td>11.80%</td>
<td>1.33%</td>
<td>4047</td>
<td>6.7%</td>
<td>128.65</td>
<td>4.47%</td>
<td>3.80%</td>
<td>0.00%</td>
</tr>
<tr>
<td>11.51%</td>
<td>-0.29%</td>
<td>4216</td>
<td>4.2%</td>
<td>138.89</td>
<td>8.0%</td>
<td>4.00%</td>
<td>0.20%</td>
</tr>
<tr>
<td>8.99%</td>
<td>-2.52%</td>
<td>4350</td>
<td>3.2%</td>
<td>125.95</td>
<td>-9.3%</td>
<td>3.80%</td>
<td>-0.20%</td>
</tr>
<tr>
<td>7.22%</td>
<td>-1.77%</td>
<td>4431</td>
<td>1.9%</td>
<td>112.89</td>
<td>-10.4%</td>
<td>1.20%</td>
<td>-2.60%</td>
</tr>
<tr>
<td>8.86%</td>
<td>1.64%</td>
<td>4633</td>
<td>4.6%</td>
<td>95.88</td>
<td>-15.1%</td>
<td>4.40%</td>
<td>3.20%</td>
</tr>
<tr>
<td>9.14%</td>
<td>0.28%</td>
<td>4789</td>
<td>3.4%</td>
<td>95.32</td>
<td>-0.6%</td>
<td>4.40%</td>
<td>0.00%</td>
</tr>
<tr>
<td>7.93%</td>
<td>-1.21%</td>
<td>4875</td>
<td>1.8%</td>
<td>102.26</td>
<td>7.3%</td>
<td>4.60%</td>
<td>0.20%</td>
</tr>
<tr>
<td>8.07%</td>
<td>0.14%</td>
<td>4895</td>
<td>0.4%</td>
<td>96.25</td>
<td>-5.9%</td>
<td>6.10%</td>
<td>1.50%</td>
</tr>
<tr>
<td>6.70%</td>
<td>-1.37%</td>
<td>4894</td>
<td>0.0%</td>
<td>98.82</td>
<td>2.7%</td>
<td>3.10%</td>
<td>-3.00%</td>
</tr>
<tr>
<td>6.69%</td>
<td>-0.01%</td>
<td>5061</td>
<td>3.4%</td>
<td>104.58</td>
<td>5.8%</td>
<td>2.90%</td>
<td>-0.20%</td>
</tr>
<tr>
<td>5.79%</td>
<td>-0.90%</td>
<td>5219</td>
<td>3.1%</td>
<td>105.22</td>
<td>0.6%</td>
<td>2.70%</td>
<td>-0.20%</td>
</tr>
<tr>
<td>7.82%</td>
<td>2.03%</td>
<td>5416</td>
<td>3.8%</td>
<td>98.6</td>
<td>-6.3%</td>
<td>2.70%</td>
<td>0.00%</td>
</tr>
<tr>
<td>5.57%</td>
<td>-2.25%</td>
<td>5503</td>
<td>1.6%</td>
<td>95.1</td>
<td>-3.5%</td>
<td>2.50%</td>
<td>-0.20%</td>
</tr>
<tr>
<td>6.42%</td>
<td>0.85%</td>
<td>5679</td>
<td>3.2%</td>
<td>101.5</td>
<td>6.7%</td>
<td>3.30%</td>
<td>0.80%</td>
</tr>
</tbody>
</table>
The answer to this question is important because it

- it provides a measure of the duration of the firm’s projects
- it provides insight into whether the firm should be using fixed or floating rate debt.
Firm Value versus Interest Rate Changes

- Regressing changes in firm value against changes in interest rates over this period yields the following regression –
  \[
  \text{Change in Firm Value} = 0.22 - 7.43 \times (\text{Change in Interest Rates})
  \]
  
  \[
  (3.09) \quad (1.69)
  \]
  
  T statistics are in brackets.

- Conclusion: The duration (interest rate sensitivity) of Disney’s asset values is about 7.43 years. Consequently, its debt should have at least as long a duration.
Regression Constraints

Which of the following aspects of this regression would bother you the most?

- The low R-squared of only 10%
- The fact that Disney today is a very different firm from the firm captured in the data from 1981 to 1996
- Both
- Neither
Why the coefficient on the regression is duration..

The duration of a straight bond or loan issued by a company can be written in terms of the coupons (interest payments) on the bond (loan) and the face value of the bond to be:

\[
\text{Duration of Bond} = \frac{\sum_{t=1}^{N} t \cdot \text{Coupon}_t}{(1+r)^t} + \frac{\sum_{t=1}^{N} \text{Face Value} \cdot \text{Coupon}_t}{(1+r)^t} + \frac{N \cdot \text{Face Value}}{(1+r)^N}
\]

Holding other factors constant, the duration of a bond will increase with the maturity of the bond, and decrease with the coupon rate on the bond.
This measure of duration can be extended to any asset with expected cash flows on it. Thus, the duration of a project or asset can be estimated in terms of the pre-debt operating cash flows on that project.

\[
\text{Duration of Project/Asset} = \frac{dPV}{dr} = \left[ \frac{\sum_{t=1}^{N} CF_t (1+r)^t + N \times \text{Terminal Value}}{(1+r)^N} \right] - \left[ \frac{\sum_{t=1}^{N} \frac{CF_t}{(1+r)^t} + \frac{\text{Terminal Value}}{(1+r)^N}}{\sum_{t=1}^{N} (1+r)^t} \right]
\]

where,
- \( CF_t \) = After-tax operating cash flow on the project in year \( t \)
- \( \text{Terminal Value} \) = Salvage Value at the end of the project lifetime
- \( N \) = Life of the project

The duration of any asset provides a measure of the interest rate risk embedded in that asset.
## Duration of Disney Theme Park

<table>
<thead>
<tr>
<th>Year</th>
<th>FCFF</th>
<th>Terminal Value</th>
<th>Total FCFF</th>
<th>PV of FCFF</th>
<th>PV * t</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>($39,078 Bt)</td>
<td>($39,078 Bt)</td>
<td>(31,180 Bt)</td>
<td>-31180.4</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>($36,199 Bt)</td>
<td>($36,199 Bt)</td>
<td>(23,046 Bt)</td>
<td>-46092.4</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>($11,759 Bt)</td>
<td>($11,759 Bt)</td>
<td>(5,973 Bt)</td>
<td>-17920</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>16,155 Bt</td>
<td>16,155 Bt</td>
<td>6,548 Bt</td>
<td>26193.29</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>21,548 Bt</td>
<td>21,548 Bt</td>
<td>6,969 Bt</td>
<td>34844.55</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>33,109 Bt</td>
<td>33,109 Bt</td>
<td>8,544 Bt</td>
<td>51264.53</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>46,692 Bt</td>
<td>46,692 Bt</td>
<td>9,614 Bt</td>
<td>67299.02</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>58,169 Bt</td>
<td>58,169 Bt</td>
<td>9,557 Bt</td>
<td>76454.39</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>70,423 Bt</td>
<td>838,720 Bt</td>
<td>119,182 Bt</td>
<td>1072635</td>
<td></td>
</tr>
<tr>
<td>Sum</td>
<td>100,214 Bt</td>
<td>100,214 Bt</td>
<td>1,233,498</td>
<td>1,233,498</td>
<td></td>
</tr>
</tbody>
</table>

Duration of the Project = 1,233,498/100,214 = 12.30 years
Duration: Comparing Approaches

Traditional Duration Measures

\[ \frac{\delta P}{\delta r} = \text{Percentage Change in Value for a percentage change in Interest Rates} \]

Uses:
1. Projected Cash Flows
2. Cash Flows are unaffected by changes in interest rates
3. Changes in interest rates are small.

Assumes:

Regression:

\[ \delta P = a + b \delta r \]

Uses:
1. Historical data on changes in firm value (market) and interest rates
2. Past project cash flows are similar to future project cash flows.
3. Relationship between cash flows and interest rates is stable.
4. Changes in market value reflect changes in the value of the firm.

Assumes:
1. Cash Flows are unaffected by changes in interest rates
2. Changes in interest rates are small.
Operating Income versus Interest Rates

- Regressing changes in operating cash flow against changes in interest rates over this period yields the following regression –
  \[ \text{Change in Operating Income} = 0.31 - 4.99 \times (\text{Change in Interest Rates}) \]
  
  \[ (2.90) \ (0.78) \]
  
  - Conclusion: Disney’s operating income, like its firm value, has been very sensitive to interest rates, which confirms our conclusion to use long term debt.

- Generally speaking, the operating cash flows are smoothed out more than the value and hence will exhibit lower duration that the firm value.
Sensitivity to Changes in GNP

The answer to this question is important because
- it provides insight into whether the firm’s cash flows are cyclical and
- whether the cash flows on the firm’s debt should be designed to protect against cyclical factors.

If the cash flows and firm value are sensitive to movements in the economy, the firm will either have to issue less debt overall, or add special features to the debt to tie cash flows on the debt to the firm’s cash flows.
Regression Results

- Regressing changes in firm value against changes in the GNP over this period yields the following regression –
  \[ \text{Change in Firm Value} = 0.31 + 1.71 \times \text{(GNP Growth)} \]
  \[ (2.43) \quad (0.45) \]
  - Conclusion: Disney is only mildly sensitive to cyclical movements in the economy.
- Regressing changes in operating cash flow against changes in GNP over this period yields the following regression –
  \[ \text{Change in Operating Income} = 0.17 + 4.06 \times \text{(GNP Growth)} \]
  \[ (1.04) \quad (0.80) \]
  - Conclusion: Disney’s operating income is slightly more sensitive to the economic cycle. This may be because of the lagged effect of GNP growth on operating income.
Sensitivity to Currency Changes

The answer to this question is important, because

- it provides a measure of how sensitive cash flows and firm value are to changes in the currency
- it provides guidance on whether the firm should issue debt in another currency that it may be exposed to.

If cash flows and firm value are sensitive to changes in the dollar, the firm should

- figure out which currency its cash flows are in;
- and issued some debt in that currency
Regression Results

- Regressing changes in firm value against changes in the dollar over this period yields the following regression –
  \[
  \text{Change in Firm Value} = 0.26 - 1.01 \ (\text{Change in Dollar})
  \]
  \[
  (3.46) \ (0.98)
  \]
  - Conclusion: Disney’s value has not been very sensitive to changes in the dollar over the last 15 years.

- Regressing changes in operating cash flow against changes in the dollar over this period yields the following regression –
  \[
  \text{Change in Operating Income} = 0.26 - 3.03 \ (\text{Change in Dollar})
  \]
  \[
  (3.14) \ (2.59)
  \]
  - Conclusion: Disney’s operating income has been much more significantly impacted by the dollar. A stronger dollar seems to hurt operating income.
The answer to this question is important, because

- it provides a measure of whether cash flows are positively or negatively impacted by inflation.
- it then helps in the design of debt; whether the debt should be fixed or floating rate debt.

If cash flows move with inflation, increasing (decreasing) as inflation increases (decreases), the debt should have a larger floating rate component.
Regression Results

- Regressing changes in firm value against changes in inflation over this period yields the following regression –

\[
\text{Change in Firm Value} = 0.26 - 0.22 \ (\text{Change in Inflation Rate})
\]

\[
(3.36) \quad (0.05)
\]

• Conclusion: Disney’s firm value does not seem to be affected too much by changes in the inflation rate.

- Regressing changes in operating cash flow against changes in inflation over this period yields the following regression –

\[
\text{Change in Operating Income} = 0.32 + 10.51 \ (\text{Change in Inflation Rate})
\]

\[
(3.61) \quad (2.27)
\]

• Conclusion: Disney’s operating income seems to increase in periods when inflation increases. However, this increase in operating income seems to be offset by the increase in discount rates leading to a much more muted effect on value.
Overall Recommendations

- The debt issued should be long term, and should have an average duration of approximately 7.5 years.
- Since the cashflows tend to weaken when the dollar strengthens, some of the debt should be in foreign currency, with the magnitude of the exposure and the currency used being determined by the mix of tourists that arrive at the theme parks and the expansion plans for the creative content and television businesses.
- Since the cash flows tend to move with inflation, a portion of the debt should be floating rate debt.
First Principles

■ Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  • The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners’ funds (equity) or borrowed money (debt)
  • Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.

■ Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.

■ If there are not enough investments that earn the hurdle rate, return the cash to stockholders.
  • The form of returns - dividends and stock buybacks - will depend upon the stockholders’ characteristics.