

Orchard Mill Development is a regional development Corporation that has as main activity preparing land parcels for residential or commercial constructions in favorable locations that were previously undeveloped. In fact, the OMD earned profit through reselling the developed estate to builders at a greater price. The company has been very successful in its operations, since it was able to engage in projects with high returns and low risk (an ideal situation), a thing that allowed the company to earn increasing returns and to make equity holders delighted due to the steady increase in earnings. During this period of high growth, the company has achieved a higher financial performance than the industry average. However, periods of high growth do not last forever; OMD is now confronted to a normal and steady growth. Therefore, the company should take into account only the projects that will add value to the company.

The firm needs to restructure its debt and equity percentages to be able to finance the totality of these projects. This is due to the fact they are all considered vital for the company and they must all be undertaken to maintain its competitive position in the market. The company should find a way of raising capital with a cost that will allow the acceptance of all these projects. The company has been able throughout the past to maintain a capital structure that was mostly made of equity and partially of debt. However, for these projects, a restructuring (50 % debt 50 % equity) was required. This means an important increase in the proportion of debt that might increase the risk for OMD due to more leveraging, and as a result, cause the stock price to decrease due to more risk. Since the company will be required to pay interest on debt, then its earnings left for common stock will decrease. Therefore, the increase in debt in normal cases results in a decrease of the value of the stock causing the cost of capital of the firm to increase.

However, OMD investors have an adverse effect that maybe explained by the fact that investors think that the company is pursuing investment opportunities, which cause future high growth in earnings. Therefore, investors would invest more in the stock causing the price of the stock to increase and the cost of capital to decrease.

Susan shue has decided to increase its debt as a percentage of total structure, and this increase has caused the cost of capital to decrease. This could be explained by the formula of the WACC. Before the restructuring:

$$WACC_1 = 0.75 * K_e + 0.25 * K_d * (1 - \text{taxes})$$

After restructuring:

$$\text{If } K_e > K_d$$

Then the $WACC_2 = 0.5 * K_e + 0.5 * K_d * (1 - \text{taxes})$. These two formulas explain why the cost of capital will decrease if the capital structure is changed to half equity, half liabilities. Consequently, without restructuring, the company will be just paying a greater cost of capital than if it modified the capital structure.

From the Marginal cost of capital schedule and the investment opportunity scale, it is clear that in both graphs project E¹ will be rejected and that the break point before restructuring is between 8.5 % to 12 %, and after restructuring, it is between 8% to 10 %. Since these projects are all judged as strategic for the company, then Susan should review its decisions on all the projects. Project E will have a positive NPV only if the cost of capital is less than 8 % ². Therefore, if OMD prefers to undertake all these projects, then it must find a capital structure that causes the cost of capital to equal 8% or less. Under these conditions, Shue must review its strategic decisions on the capital structure that she wants to choose and also the projects that the company

¹ See Appendix for the MCC & IOS before and after restructuring.

² See Appendix the NPV for the projects.

wants to undertake. Shue must then undertake only the project that will add value to the firm, making shareholders happy. In addition, it must maintain the same level of performance as before. Indeed, the forecasts have ensured that the firm will have a steady growth rate in future years, and the firm intends to make shareholders benefit from that through allocating dividends that would grow at the same rate. Given that the capital structure surely affects the return and the raising of external funds, which is an important part of strategic decisions, then, any capital budgeting process should include the strategic considerations chosen their effects on returns. So, do they add value to the firm? In this manner only value adding strategies must be undertaken (value based management) in order to increase shareholders wealth.

After restructuring, the firm's stockholders might change their position due to a decrease in the growth rate of earnings. In fact, they used to enjoy high growth through the past projects that offered high rate of return with small risk (high growth period). The firm now is experiencing a steady rate of growth because it is undertaking projects that involve a certain risk. In fact, even if the company benefits from the adverse effect on its price and raises its debts, old shareholders might not accept that modest steady growth rate and might decide to sell their stocks, which causes the company's stockholder clientele to change. In fact, this adverse effect has a positive outcome on the stock prices; since the cost of capital decreases, the stock price will increase. However, investors in the long run might become aware of the fact that high growth period is resolved, and that the company now is experiencing steady growth. Therefore, the increase in stock prices will not last long since adjustments by investors will be made later on in order to adjust for the increase in debt and the equivalent increase in risk.

In spite of this, Shue could attempt other activities to sustain the prices at a certain level. She can, for instance, use the media to better explain the position of the company, and to show that OMD is on its way to undertake projects with growth opportunities that will have a positive

effect on earnings and on the firm's value thereafter. Actually, she can also publish the annual report of the company showing the positive trend in its financial performance, explaining the increase in earnings, and the investment project that the firm is faced with that will increase the firm's value. This could also be done through the stockholder's annual meeting by explaining to them the strategic considerations of the company and the competitive position that the company intends to maintain in the industry.

The macroeconomic environment could also affect the restructuring because the prevailing interest rate in the market might increase to cause the cost of capital for the company to increase also. Indeed, the state of the economy can also affect the restructuring operation since in case of recessions when capital is hard to obtain, the company would incur a greater cost of capital in order to collect sufficient funds. In addition, inflation will also affect the WACC because the cost of equity and cost of debt will both increase, causing the cost of capital of the company to increase also.

As a final point, Susan Shue is conscious of external information that the shareholders are not aware of. This market imperfection causes shareholders to interpret the restructuring in a different way. In fact, shareholders could either interpret it as a financial distress that the company faces or as an investment opportunity that might increase value for the firm. These interpretations have each different outcome that will result in opposite effects on the price of the stock. Hence, to reestablish market stability, Shue needs to disclose information about ODM in the aim of making all shareholders benefit from symmetric information and inform them of the expected modest steady growth rate in earnings.

