CTP Study Notes

Topic 2 · Capital Structure & Long-Term Financing

how the firm funds itself for the long haul — debt vs equity

Big idea: Blend debt & equity to fund the business at the **LOWEST cost (WACC)** without taking on too much risk.

A) Capital Structure & Long-Term Funding

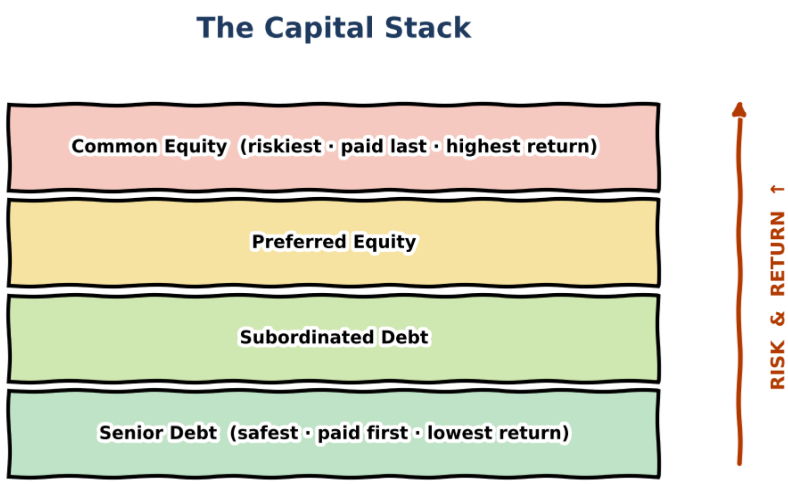
WACC — the cost of your money mix

- → **WACC** = (wD × rD × (1−T)) + (wE × rE)
- → **Debt is cheaper** — interest is tax-deductible (the **tax shield**).
- → **Equity is pricier** — no shield, investors want a higher return.

✎ REMEMBER

Debt looks cheap because of the **TAX SHIELD**.

But more debt = more risk. **Leverage cuts BOTH ways.**



The capital stack: safest & cheapest at the bottom

> ✎ **TRICK**
>
> Lower in the stack = **paid first = safer = cheaper.** Common equity is last in line (riskiest).

Long-term instruments

- → **Bonds** (coupon, maturity, indenture with covenants), term loans.
- → **Syndicated loan** = many lenders share one big loan. **Revolver** = reusable credit line.
- → **Equity** = common & preferred shares, raised via IPO or secondary offering.

> ✎ **WATCH**
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> **Covenants** = promises to lenders (e.g. keep debt/EBITDA under X). Break one = **technical default.**

B) Investment Analysis, Valuation & Hedging

Time Value of Money (TVM)

→ A dollar today > a dollar tomorrow. Discount future cash flows back to today (PV).

> ✎ **DECISION RULE**
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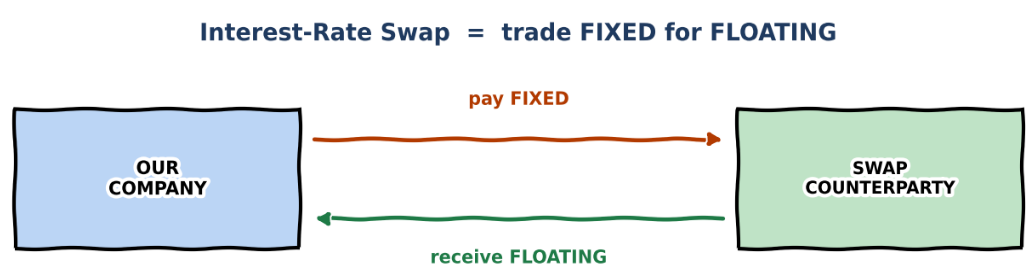
> NPV > 0 → accept (creates value). IRR = the rate that makes NPV = 0.

Treasury investment portfolio

> ✎ **REMEMBER — S · L · Y**
>
> Treasury invests in this order: SAFETY → LIQUIDITY → YIELD. Never chase yield first!

Hedging with derivatives

→ **Forwards** (custom, OTC) · **Futures** (standardized, exchange) · **Options** (a right, not a duty) · **Swaps** (exchange cash flows).



Interest-rate swap: pay fixed, receive floating

> ✎ **REMEMBER**
>
> **Swap** = trade FIXED for FLOATING. **Option** = pay a PREMIUM for the right, not the obligation.

Returning cash to owners

→ **Dividends** = regular cash payout. **Buyback** = repurchase shares (shrinks share count, lifts EPS).

★ 30-SECOND RECAP

Fund cheaply via **WACC**; mind the tax shield & leverage.

Value projects with **NPV/IRR**; invest **Safety>Liquidity>Yield**.

Hedge rate/FX risk with forwards, futures, options & swaps.