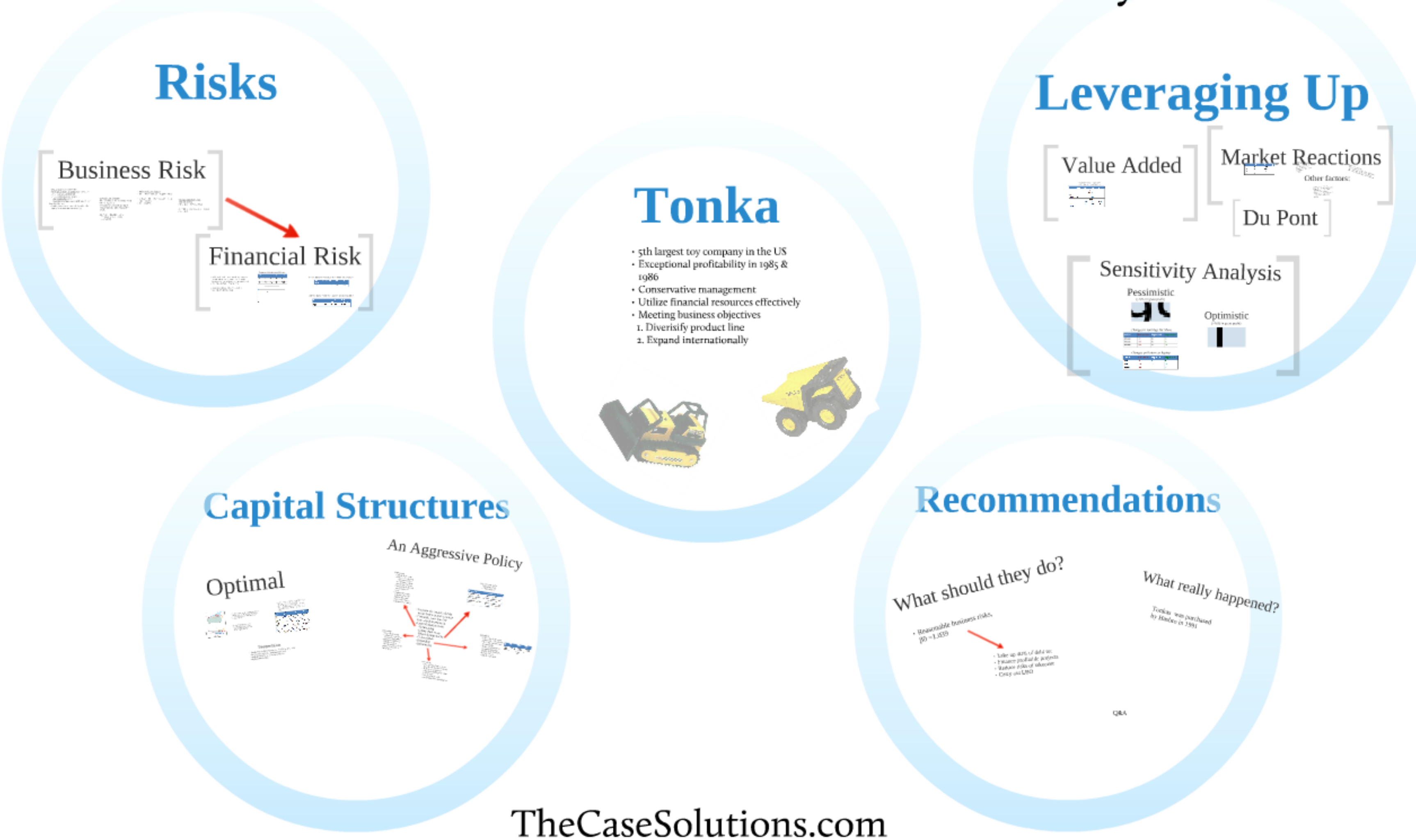
Tonka Inc Harvard Case Solution & Analysis



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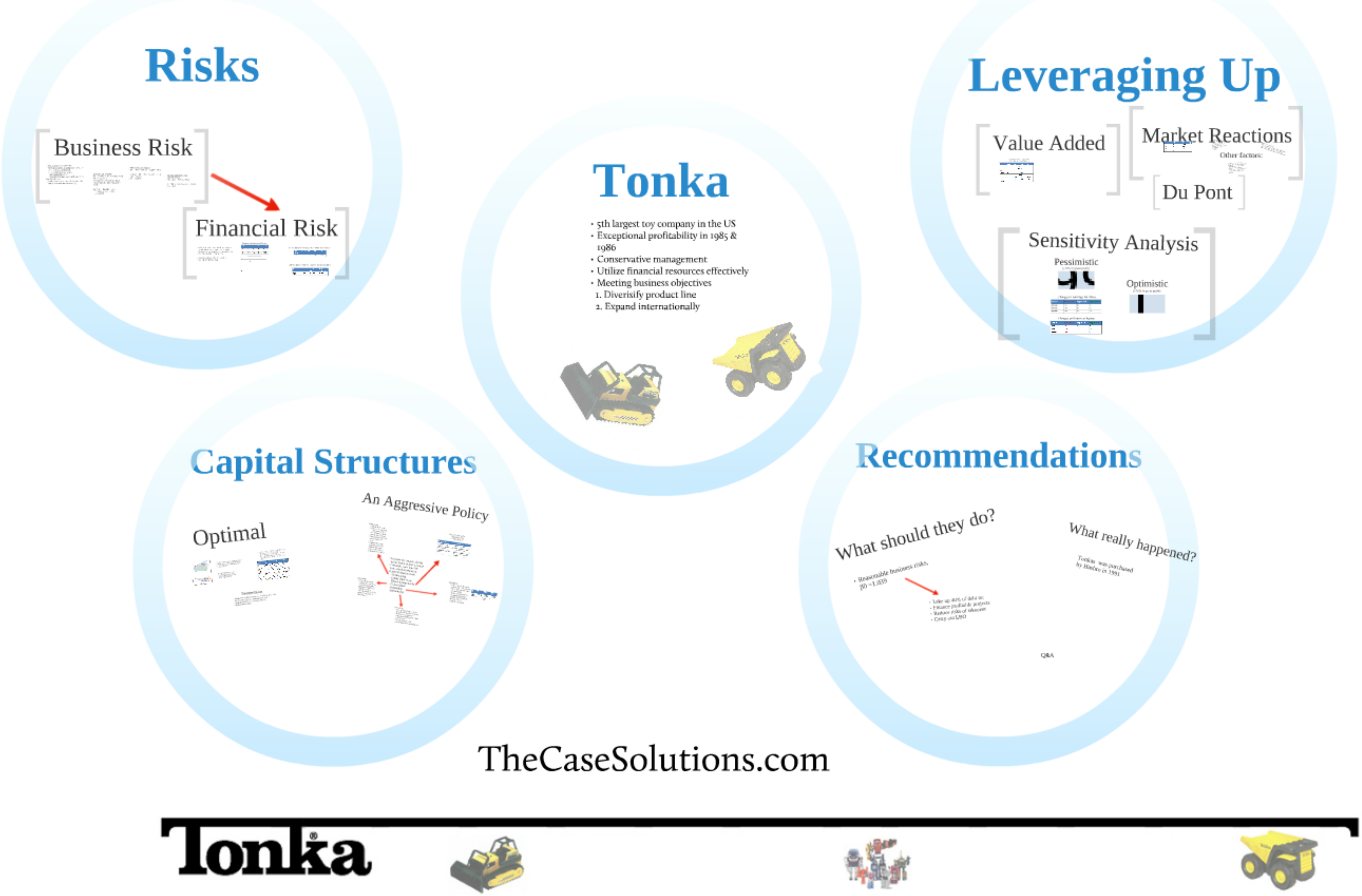

Tonka

- 5th largest toy company in the US
- Exceptional profitability in 1985 & 1986
- Conservative management
- Utilize financial resources effectively
- Meeting business objectives
  1. Diverisify product line
  2. Expand internationally

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Risks

Business Risk

- Part of Total Corporate Risks
- Risks associated with company's operations
  - Uncertainty about demand
  - Uncertainty about output prices
  - Uncertainty about costs
  - Operating leverage: use of fixed costs rather than variable costs.
- Tanka: Seasonal demand, short product life cycle, hit-or-miss nature, inventory

- Levered Cost of Equity

- Unlevered Cost of Equity

- Hamada Equation to find Unlevered Beta

Financial Risk

- Additional risk concentrated on common stockholders as a result of financial leverage, i.e. use of debt or preferred stock

- Assuming riskless debt, $\beta D = 0$, thus

Times Interest Earned (TIE) = EBIT/Interest Exp

Current Ratio = Current Assets/Current Liabilities

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- Levered Cost of Equity
- RF = 7.08% (10-Yr Treasuries Bond)
- βE = 1.1 (given)
- RM (S&P 87'Jan & 86'Jan stock prices)=246.45 – 208.19/208.19 = 18.4%

- RE = RF + βE (RM – RF)
  = 7.08+1.1(18.4 - 7.08)
  = 19.532%

- Unlevered Cost of Equity
- RE = R0 + D/E (1 – TC)(R0 – RD)

- 0.19532 = R0 + (16.7/155.5)(1 – 0.45) (R0 – 0.075)
- R0 = 18.86%

- Hamada Equation to find Unlevered Beta
- βE = $\beta 0$[1 + D/E(1 – TC)]

- 1.1= $\beta 0$ [1 + 16.7/155.5 (1 – 0.45)]
- $\beta 0$ =1.039

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- Hamad
Unlever
- $\beta E = \beta$

- $1.1 = \beta 0$
- $\beta 0 = 1.0$