

- 4 Toltuck Co is a listed company in the building industry which specialises in the construction of large commercial and residential developments. Toltuck Co had been profitable for many years, but has just incurred major losses on the last two developments which it has completed in its home country of Arumland. These developments were an out-of-town retail centre and a major residential development. Toltuck Co's directors have blamed the poor results primarily on the recent recession in Arumland, although demand for the residential development also appears to have been adversely affected by it being located in an area which has suffered serious flooding over the last two years.

As a result of returns from these two major developments being much lower than expected, Toltuck Co has had to finance current work-in-progress by a significantly greater amount of debt finance, giving it higher gearing than most other construction companies operating in Arumland. Toltuck Co's directors have recently been alarmed by a major credit agency's decision to downgrade Toltuck Co's credit rating from AA to BBB. The directors are very concerned about the impact this will have on the valuation of Toltuck Co's bonds and the future cost of debt.

The following information can be used to assess the consequences of the change in Toltuck Co's credit rating.

Toltuck Co has issued an 8% bond, which has a face or nominal value of \$100 and a premium of 2% on redemption in three years' time. The coupon on the bond is payable on an annual basis.

The government of Arumland has three bonds in issue. They all have a face or nominal value of \$100 and are all redeemable at par. Taxation can be ignored on government bonds. They are of the same risk class and the coupon on each is payable on an annual basis. Details of the bonds are as follows:

Bond	Redeemable	Coupon	Current market value
			\$
1	1 year	9%	104
2	2 years	7%	102
3	3 years	6%	98

Credit spreads, published by the credit agency, are as follows (shown in basis points):

Rating	1 year	2 years	3 years
AA	18	31	45
BBB	54	69	86

Toltuck Co's shareholder base can be divided broadly into two groups. The majority of shareholders are comfortable with investing in a company where dividends in some years will be high, but there will be low or no dividends in other years because of the cash demands facing the business. However, a minority of shareholders would like Toltuck Co to achieve at least a minimum dividend each year and are concerned about the company undertaking investments which they regard as very speculative. Shareholders from both groups have expressed some concerns to the board about the impact of the fall in credit rating on their investment.

Required:

- (a) Calculate the valuation and yield to maturity of Toltuck Co's \$100 bond under its old and new credit ratings. (10 marks)
- (b) Discuss the factors which may have affected the credit rating of Toltuck Co published by the credit agency. (8 marks)
- (c) Discuss the impact of the fall in Toltuck Co's credit rating on its ability to raise financial capital and on its shareholders' return. (7 marks)

(25 marks)