

Finance Mini Case

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## Finance Mini Case

Toyota Motor Corporation (“Toyota”) is a Japanese automobile manufacturer that was founded by Kiichiro Toyoda in 1937 (Toyota Motor Corporation, 2015). The company manufactures a variety of automobiles such as standard cars, sports utility vehicles, trucks, vans, hybrid vehicles and commercial vehicles offered to commercial and government customers as well as consumers. As an automobile manufacturer, the company operates in the Car & Automobile Manufacturing offers its products and services to customers throughout the United States and internationally. In addition to automobile manufacturing, the company also provides a range of financing services including “retail financing, retail leasing, wholesale financing, insurance, and credit cards” (Yahoo Finance, 2015, para. 1).

**Capital Structure & Risks**

Operating risks are risks that companies are automatically exposed to because of the industry or industries where they operate. Operating risks may vary from the company’s exposure to macro-environmental factors such as political, economic, social, and technology risk to other issues that directly affect an industry. Operating risks that affect Toyota vary according to their respective markets. Some factors have a higher risk in some markets and lower risks in others. However, some risks affect the company at the same level of intensity, despite their location or the markets served. One of the major operating risks that are common in all markets where Toyota operates is the competitiveness of the worldwide automotive industry (Toyota, 2014). Presently, the company has to continuously improve or reinvent its products to compete with other international industry leaders such as Honda, Nissan, Volkswagen, and General Motors. Another operating risk is the volatility of the worldwide automotive industry (Toyota, 2014). Various factors, specifically economic factors, have the largest impact on sales. Because the company operates in various markets, volatile economic conditions, specifically in larger markets, can have a tremendous impact on sales.

Toyota's financial risk may be measured in various forms, such as comparing changes in debt over multiple periods and reviewing financial statements. However, a more effective measure is to calculate the debt-to-total capitalization ratio. This ratio is used to compare a company's level of debt to its total capital and is calculated by dividing total debt by total capital (shareholders' equity + debt) (Wideman & Holman, 2014). In 2014, Toyota had ¥22.71 trillion in total debt and ¥35.48 trillion in total capital. As a result, the company's debt-to-total capitalization ratio was 1.56, which means it had ¥1.56 in debt for every ¥1 in capital as of the end of the 2014 fiscal year.

A company's capital structure may be further identified by analyzing four components, which include short-term portion of long-term debt, long-term debt, preferred stock, and market value of common stock issued and outstanding. Toyota does not issue preferred stock. According to the notes to its 2014 financial statements "None of Toyota's shares of common stock entitles the holder to any preferential voting rights" (Toyota, 2014). However, it does have short-term portions of long-term debt, long-term debt, and market values for common stock issued and outstanding. As of the end of the 2014 fiscal year, Toyota short-term portion of long-term debt was ¥2.70 trillion; total long-term debt was ¥9.80 trillion; preferred stock did not exist; and the market value common stock issued and outstanding was ¥395.05 billion (Toyota, 2014).

Another measurement that assesses a company's capital structure is beta. Beta measures the volatility levels that investors can expect from a specific stock and is based on how a stock's price rises or falls in its respective stock markets, thus it exhibits investors' abilities to either lose money or make money on stocks (Lebanon, 2015). Investors may identify a stock's volatility levels by its beta number. Betas with higher numbers tend to rise or fall quickly while smaller betas move at a slower pace. For example, a stock with a beta of 1.5 will likely rise or fall 1.5 times as fast or as slow as the market. Toyota has a beta of 0.75; therefore, its stock will rise or fall in about half of the time as the stock in the example, thus move slower. However, Toyota's current beta could be higher if certain components of its capital structure were lower. For example, the company had total

debt of ¥22.71 trillion at the end of the 2014 fiscal year. If the company's debt was 50 percent less than the current amount, the beta would likely change to a rate between 0.75 and 1.5.

### **Taxes, Debt, & Interest**

Between 2013 and 2014, Toyota experienced a significant increase in income tax expenses. The tax expenses increased from ¥551.7 billion to ¥767.8 billion or 32.9 percent. Fortunately, the company's effective tax rate was only 31.5 percent, which was less than the previous year. The decreased effective tax rate was the result of the company receiving additional tax credits, an increase in equity in earnings, and changes to its income before income taxes (Toyota, 2014).

A company's cost of debt reflects the interest rates that it pays on its debts. This amount may be measured in terms of dollar amounts or percentages and may be analyzed using either after tax or post tax dollars, but it is typically measured by percentages and using before tax dollars (Fernandez, 2011). The cost of debt is calculated by multiplying a company's weighted-average interest rate by 1 minus its marginal tax rate. As of the 2014 fiscal year, Toyota's weighted-average interest rate was approximately 3.06 percent and its tax rate was 31.5 percent (Toyota, 2014). Using this information with the cost of debt formula yields a cost of debt of 2.10 percent  $[0.0306 \times (1 - .315)]$ .

The cost of equity is the return that stockholders aim to receive from a company and it is determined by dividing dividends per share for the upcoming year by the most recent market value of stock plus the dividends growth rate (Fernandez, 2011). Toyota's fiscal year begins in March and ends in February of each year. For the first eleven months of the 2015 fiscal year, Toyota did not pay dividends, which yields \$0 for the dividends per share for the upcoming year. Therefore, the cash dividend yield on common stock and cost of equity is zero.

Weighted-average cost of capital (WACC), another measurement of a company's debt, is defined as "the rate that a company is expected to pay on average to all its security holders to finance its assets" (Fernandez, 2011, p. 14). This measure assists investors with identifying the balance among all of a company's investments and debts and provides insight at the usage and/or acceptance of risk for various assets and liabilities listed in the financial statements. Toyota

measures its WACC as it applies to loans primarily from banks and commercial paper. According to the company, the weighted average on loans from banks was 2.57 percent and 0.49 percent for commercial paper for the 2014 fiscal year (Toyota, 2014).

### **Stock Performance**

A company's stock performance may be analyzed using two common measures, the price-earnings ratio and by analyzing changes in stock prices over a particular period. The price-earnings multiple is determined by obtaining a company's price-earnings ratio. The price-earnings ratio is used to evaluate a company's stock and is determined by dividing the market price per share by the earnings per share (Westerfield, n.d.). In the case of Toyota, this information is given on Yahoo Finance. According to Yahoo Finance, the company's price-earnings ratio is 12.34 (2015).

Information about Toyota's stock performance can also be found on Yahoo Finance. To ensure sufficient information about stock trends is analyzed Toyota's stock performance for the last five years, specifically on or around January 15, 2011; January 15, 2012; January 15, 2013; January 15, 2014; and January 15, 2015. On January 14, 2011, the company's stock price was \$85.96; \$67.64 on January 17, 2012; \$96.43 on January 15, 2013; \$119.47 on January 15, 2014; and \$126.78 on January 15, 2015 (Yahoo Finance, 2015).

Between 2011 and 2012, Toyota's stock price decreased by \$18.32 or 27 percent. Between 2012 and 2013, the stock price increased by \$28.79 or 42.56 percent from \$67.64 to \$96.43. Between 2013 and 2015, Toyota's stock prices continued to increase, but at a much slower rate. Between 2013 and 2014, the stock price increased by \$23.04 or 23.89 percent, which was significantly less than the 42.56 percent year-to-year increase from the prior two years. The stock prices also experienced slow growth between 2014 and 2015. On January 15, 2014 and January 15, 2015, the stock price increased by \$7.31 or 6.12 percent. As noted in the activity, Toyota's stock prices experienced an unexpected decrease between 2011 and 2012. However, stock prices quickly recovered in the following year. While growth in stock prices continued through the current date, it did so at a much slower pace.

The overall operating and financial risks associated with Toyota does not display any activities that make it more or less vulnerable than any other companies in the industry. Toyota's performance and its ability to respond to market trends is a clear indication of its ability to identify risks and quickly respond to them to remain competitive in the market. Because of these qualities, I would invest in the company. During a five-year period, the company only had one moment of questionable stock performance, but it quickly rebounded yielding a total return of more than 47 percent on the stock price and had a return of more than 87 percent from the date the stock price decrease.

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