



Corporate Finance: Capital Structure, Investment Appraisal and Value Creation

*A Critical Case Study Analysis of Financing Decisions, Risk and
Shareholder Wealth Maximisation*

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1. INTRODUCTION AND CASE CONTEXT

Corporate finance concerns the financial decisions made by corporations and the tools and analytical frameworks employed to make those decisions. Its central objective, as articulated by Jensen and Meckling (1976), is shareholder wealth maximisation — expressed as the maximisation of the market value of the firm's equity. This objective is, however, theoretically contested and practically nuanced: agency conflicts, information asymmetries, market imperfections and stakeholder obligations collectively complicate the pursuit of a single financial objective function (Freeman, 1984; Stout, 2012).

This case study critically examines the principal domains of corporate finance through the lens of a fictitious manufacturing conglomerate, **Meridian Industries plc** — a UK-listed company operating across three divisions (aerospace components, industrial automation and renewable energy systems). Meridian is evaluating a major capital expenditure programme, revisiting its capital structure following a credit rating downgrade, and considering a change to its dividend policy. This context provides a practical anchor for evaluating capital structure theory, WACC, investment appraisal, dividend policy, agency theory and financial risk management.

2. CAPITAL STRUCTURE THEORY

2.1 Modigliani-Miller Propositions (1958, 1963)

The foundation of modern capital structure theory rests upon Modigliani and Miller's (1958) celebrated irrelevance propositions. Under idealised conditions — perfect capital markets, no taxes, no transaction costs, no bankruptcy costs and symmetric information — MM demonstrated mathematically that a firm's value is independent of

its financing structure. Leverage merely redistributes risk between debt-holders and equity-holders; it cannot create value. This "irrelevance theorem" established a theoretical benchmark whose assumptions, upon systematic relaxation, illuminate the real-world determinants of optimal capital structure.

The 1963 correction introduced corporate taxation, demonstrating that the tax deductibility of interest creates a "tax shield" — a present value benefit equal to the tax rate multiplied by total debt — that increases firm value with leverage. This implies a corner solution: firms should maximise debt to maximise tax shields, an empirically implausible prediction. For Meridian, operating at a gearing ratio of 42% (debt to total capital), the existence of a substantial tax shield (estimated at £28.4m at a 25% UK corporation tax rate on £113.6m of interest-bearing debt) represents a material source of financial value — but one that must be weighed against the rising costs of financial distress as leverage increases.

MM (1958) — NO TAXES Capital structure is irrelevant to firm value in perfect markets. $V_L = V_U$ <i>Limitation: Perfect market assumptions do not hold in practice</i>	MM (1963) — WITH CORPORATE TAX Debt creates a tax shield increasing firm value. $V_L = V_U + T_c D$ <i>Limitation: Implies 100% debt — empirically refuted</i>
TRADE-OFF THEORY Optimal leverage balances tax shield benefits against financial distress and agency costs. $V_L = V_U + PV(\text{Tax Shield}) - PV(\text{Distress Costs})$ <i>Limitation: Distress costs are difficult to quantify ex ante</i>	PECKING ORDER THEORY (MYERS & MAJLUF, 1984) Firms prefer internal finance, then debt, then equity — driven by information asymmetry costs. <i>Limitation: Cannot explain persistent high-dividend, cash-rich firms</i>

Figure 1: Capital Structure Theories — Core Propositions and Limitations. Sources: Modigliani and Miller (1958, 1963); Myers and Majluf (1984).

2.2 Trade-Off Theory

The Static Trade-Off Theory (Kraus and Litzenberger, 1973; Myers, 1977) posits that firms select a target leverage ratio at which the marginal value of the interest tax shield equals the marginal present value of financial distress costs — including direct bankruptcy costs (legal fees, asset fire-sale discounts) and indirect costs (lost customers, key employee attrition, underinvestment in positive-NPV projects due to debt overhang). For Meridian, recent Moody's downgrade to Ba1 signals

that markets perceive the balance as tipping toward distress — a critical signal that should prompt a strategic de-leveraging programme. Empirical support for the trade-off theory is broadly positive: Graham and Harvey's (2001) landmark survey of 392 CFOs found that firms actively target leverage ratios, with tax considerations cited as the primary determinant of capital structure decisions.

2.3 Pecking Order and Market Timing Theories

Myers and Majluf (1984) proposed that information asymmetry between managers and outside investors generates a "pecking order" of financing preferences: internal retained earnings (no adverse signalling), then debt (modest adverse signal), then equity (strongest adverse signal, as markets infer managers believe shares are overvalued). This theory predicts that profitable, cash-generative firms will be less leveraged — consistent with observed behaviour. Baker and Wurgler (2002) extended this with Market Timing Theory, arguing that capital structure is the cumulative outcome of managers' historical attempts to issue equity when shares appear overvalued and repurchase when undervalued. Critically, these theories are descriptively powerful but normatively limited: they explain how firms finance themselves without prescribing an optimal structure, making them insufficient as standalone guides for Meridian's restructuring decision.

3. THE WEIGHTED AVERAGE COST OF CAPITAL (WACC)

3.1 WACC Calculation — Meridian Industries plc (Illustrative)

The WACC represents the blended cost of a firm's capital from all sources, weighted by their respective proportions in the target capital structure. It serves as the appropriate discount rate for investment appraisal when the project preserves the firm's existing risk profile. The formula is: $WACC = K_e(E/V) + K_d(1-T_c)(D/V)$, where K_e is the cost of equity, K_d is the pre-tax cost of debt, T_c is the corporate tax rate, E is market value of equity, D is market value of debt and $V = E + D$.

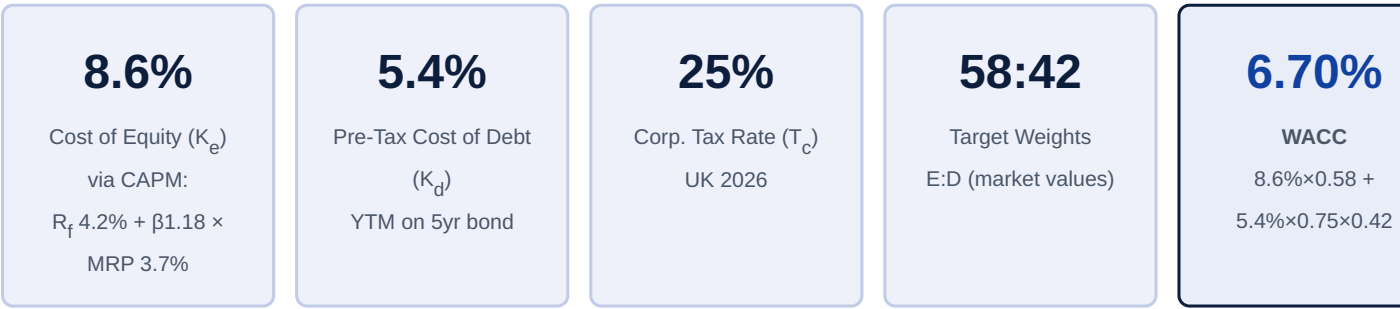


Figure 2: WACC Components and Calculation — Meridian Industries plc (Illustrative). All figures are fictitious and for educational purposes only.

3.2 Critical Limitations of WACC

The WACC framework, despite its ubiquity in corporate practice — cited by 73.5% of CFOs surveyed by Graham and Harvey (2001) — embeds significant methodological limitations. First, the cost of equity is typically estimated via the Capital Asset Pricing Model (CAPM), which assumes that only systematic (market) risk is priced, that beta is stable and that the market portfolio is observable — assumptions subject to extensive empirical challenge (Fama and French, 1992). Second, WACC assumes a constant, perpetual capital structure at the target weights, yet real-world firms deviate substantially and dynamically from any target. Where project financing significantly alters leverage, the Adjusted Present Value (APV) method — which separately values the unlevered firm and the financing side-effects — is theoretically superior (Miles and Ezzell, 1980). Third, using a single firm-wide WACC to

appraise projects with differing risk profiles leads to systematic capital misallocation: high-risk projects will be underpriced and low-risk projects overpriced. Divisional WACCs or project-specific discount rates, derived by identifying pure-play comparable firms (the "proxy beta" approach), are the theoretically preferred solution (Brealey, Myers and Allen, 2023).

4. INVESTMENT APPRAISAL TECHNIQUES

4.1 Net Present Value (NPV)

Net Present Value (NPV) is the theoretically preferred investment appraisal technique, consistent with the objective of shareholder wealth maximisation. NPV discounts all incremental, after-tax cash flows of a project at the appropriate risk-adjusted discount rate and subtracts the initial outlay. A positive NPV indicates that the project generates returns in excess of the cost of capital, thereby creating value for shareholders (Brealey, Myers and Allen, 2023).

Table 1: NPV Appraisal — Meridian Industries plc: Project NOVA (Renewable Energy Expansion) — Illustrative

Year	Cash Flow (£m)	Discount Factor (6.70%)	PV of Cash Flow (£m)
Year 0 (Initial Outlay)	(85.00)	1.000	(85.00)
Year 1	18.40	0.9372	17.24
Year 2	22.10	0.8783	19.41
Year 3	25.80	0.8231	21.24
Year 4	29.30	0.7714	22.60
Year 5 (incl. terminal value £38m)	66.50	0.7230	48.08
NPV			+£43.57m ✓ ACCEPT

Note: All figures are fictitious and produced solely for educational illustration. Discount rate = WACC 6.70%. Terminal value estimated using Gordon Growth Model at 2% perpetual growth.

4.2 Internal Rate of Return (IRR) and MIRR

The IRR is the discount rate at which a project's NPV equals zero. It is frequently used in practice as a summary return metric — a survey by KPMG (2020) found that 74% of UK corporates use IRR alongside NPV

for major capital allocation decisions. Project NOVA's IRR of 14.8% comfortably exceeds Meridian's WACC of 6.70%, reinforcing the NPV-positive appraisal. However, the IRR is subject to three well-documented deficiencies. First, it can produce multiple solutions when cash flows change sign more than once (Descartes' Rule of Signs). Second, it implicitly assumes that interim cash flows are reinvested at the IRR itself rather than at the opportunity cost of capital — an assumption typically violated in practice. Third, when ranking mutually exclusive projects of different scale, IRR favours smaller projects with higher percentage returns but lower absolute value creation (Brealey, Myers and Allen, 2023).

The Modified Internal Rate of Return (MIRR) resolves the reinvestment assumption by explicitly reinvesting interim cash flows at the cost of capital. Project NOVA's MIRR of 11.2% — lower than the IRR of 14.8% but still well above WACC — confirms the accept decision whilst providing a more realistic return estimate. For Meridian, NPV remains the primary decision rule; IRR and MIRR serve as communication tools for the Board and non-finance stakeholders.

4.3 Payback Period and Critical Evaluation

Table 2: Investment Appraisal Summary — Project NOVA vs Project APEX (Mutually Exclusive) — Illustrative

Criterion	Project NOVA (Renewable Energy)	Project APEX (Automation Upgrade)	Decision Rule	Preferred Project
Initial Outlay	£85.0m	£42.0m	N/A	—
NPV	+£43.57m	+£18.20m	Higher NPV	NOVA ✓
IRR	14.8%	19.3%	> WACC (6.70%)	APEX X (misleading)
MIRR	11.2%	13.6%	> WACC (6.70%)	APEX X (misleading)
Payback Period	3.6 years	2.8 years	Shorter payback	APEX X (ignores TVM)
Discounted Payback	4.2 years	3.4 years	Shorter payback	APEX X (ignores TVM post-PB)
Wealth-Maximising Decision (NPV Rule)				PROJECT NOVA

Note: All figures are fictitious. The table illustrates how IRR ranking contradicts NPV for mutually exclusive, scale-different projects — demonstrating NPV's theoretical superiority.

Table 2 crystallises a critical distinction in investment appraisal: for mutually exclusive projects of different scale, IRR can rank projects in the opposite order to NPV — the metric most directly aligned with shareholder wealth. Project APEX's higher IRR (19.3%) reflects its smaller scale; NOVA creates £43.57m of absolute value versus APEX's £18.20m. The payback period — despite its widespread use in practice as a liquidity and risk proxy — ignores the time value of money entirely and disregards all cash flows beyond the payback horizon, making it unsuitable as a primary decision criterion (McLaney, 2021). For Meridian, the Board's preference for simple payback metrics (historically applying a 3-year payback hurdle) reflects a behavioural bias toward liquidity and loss aversion rather than value creation — a

finding consistent with agency theory literature on managerial short-termism (Stein, 1989).

5. DIVIDEND POLICY AND PAYOUT DECISIONS

Meridian's Board is evaluating whether to cut its dividend — currently £0.28 per share (yield 3.4%) — in order to redirect retained earnings toward the Project NOVA capital programme. This decision intersects three major theoretical traditions. Miller and Modigliani (1961) demonstrated that, in perfect capital markets, dividend policy is irrelevant to firm value: investors can "home-make" any desired income stream by selling shares, and the firm's investment policy is the sole determinant of value. This dividend irrelevance proposition underpins a "residual" approach to payout, where dividends are paid only from earnings surplus after all positive-NPV investments are funded.

"Under conditions of certainty and in the absence of taxes and transaction costs, the market value of the firm is independent of its dividend policy."
— Miller and Modigliani (1961, p. 412)

Real-world market imperfections, however, render dividend decisions consequential. The Signalling Hypothesis (Bhattacharya, 1979) contends that dividends convey private managerial information about future earnings prospects: an unexpected dividend cut is typically interpreted as a negative signal, often triggering significant share price declines. Empirical evidence from the UK market confirms this: Benartzi, Michaely and Thaler (1997) documented that unexpected dividend reductions are followed by negative abnormal returns of 3–5% on announcement. For Meridian, whose shares have already underperformed the FTSE 250 by 12% over the past year, a dividend cut risks compounding sentiment deterioration. The Tax Preference Theory (Litzenberger and Ramaswamy, 1979) adds a further dimension: where dividends are taxed at higher rates than capital gains — as in the current UK regime — investors in higher tax brackets prefer retention and capital appreciation over distributed income, suggesting that a scrip dividend or share buyback programme may be tax-efficient

alternatives to cash dividends for Meridian's institutional shareholder base.

6. AGENCY THEORY, CORPORATE GOVERNANCE AND VALUE

Jensen and Meckling's (1976) theory of the firm identifies the agency relationship — in which principals (shareholders) delegate decision-making authority to agents (managers) — as a fundamental source of value destruction. Agency costs arise when managers pursue private objectives diverging from shareholder wealth maximisation: excessive perquisite consumption, empire-building acquisitions, entrenchment strategies and short-termism driven by compensation structures tied to earnings-per-share targets (Jensen, 1986). For Meridian, evidence of potential agency conflicts is visible: the Board's historical preference for payback-period hurdles (limiting strategic investment horizons), a diversification acquisition in 2023 that destroyed £31m of shareholder value (as measured by event-study excess returns), and executive remuneration packages weighted toward short-term earnings bonuses.

Corporate governance mechanisms serve to align managerial incentives with shareholder interests and to protect stakeholder rights more broadly. The UK Corporate Governance Code (FRC, 2024) establishes a principles-based framework requiring independence of non-executive directors, transparency in remuneration policy, rigorous audit committee oversight and meaningful shareholder engagement. For Meridian — listed on the London Stock Exchange's Main Market — compliance is a regulatory expectation, but box-ticking compliance without substantive engagement represents a governance risk in itself. Agency theory predicts that high-quality governance reduces the cost of equity through lowered information asymmetry and reduced risk premia, a proposition empirically supported by Gompers, Ishii and Metrick (2003), who found that US firms with stronger shareholder rights generated significantly higher risk-adjusted returns over the 1990–1999 period.

7. FINANCIAL RISK MANAGEMENT

Meridian's international operations — with 38% of revenues denominated in USD and EUR, and significant commodity exposure through aerospace-grade aluminium and titanium inputs — create material financial risk exposures that, if unmanaged, could impair cash flow predictability, undermine investment planning and increase the probability of financial distress (Smithson and Simkins, 2005). The firm currently employs a selective hedging approach, hedging 60% of its 12-month rolling foreign currency receipts using forward contracts and currency options.

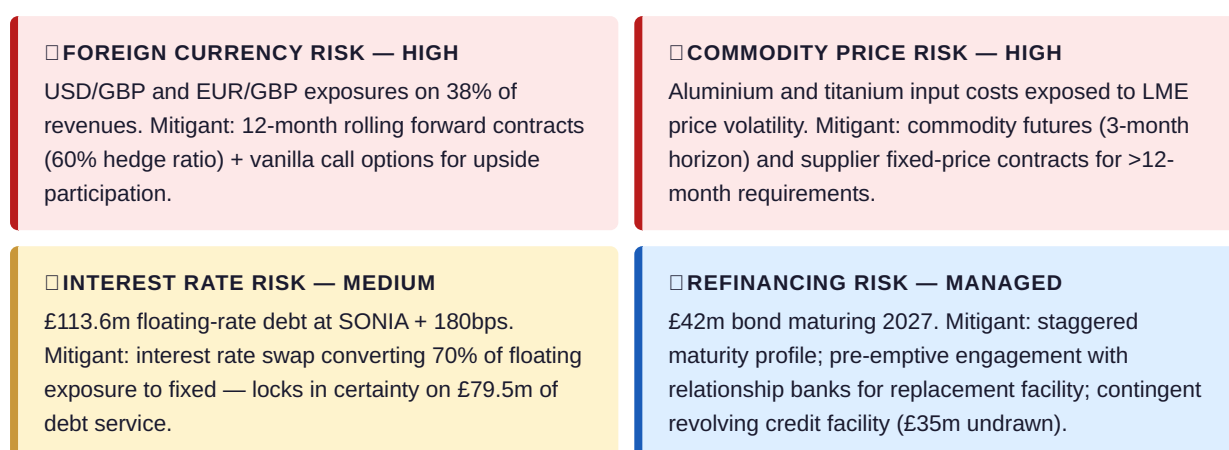


Figure 3: Meridian Industries plc — Financial Risk Profile and Hedging Strategy. Illustrative; all figures are fictitious.

The theoretical case for corporate hedging is, however, contested within the Modigliani-Miller framework: if capital markets are perfect and investors can diversify financial risks in their own portfolios, corporate hedging cannot create value (Modigliani and Miller, 1958). Froot, Scharfstein and Stein (1993) provided the canonical rebuttal: when external finance is more expensive than internal finance — due to information asymmetry and flotation costs — corporations that hedge cash flows reduce reliance on costly external funding, enabling them to fund positive-NPV investments without sacrificing the tax shield benefits of leverage. For Meridian, with a Ba1 credit rating and elevated refinancing costs, cash flow volatility reduction through hedging

directly reduces the probability of underinvestment — a value-creating rationale consistent with the theory of the firm.

Critically, however, hedging instruments are not cost-free: option premiums, margin requirements on futures and basis risk (where the hedging instrument does not perfectly offset the underlying exposure) introduce transaction costs and execution risk (Hull, 2021). Meridian's treasury team must rigorously evaluate hedge effectiveness under IFRS 9's requirements for hedge accounting designation, ensuring that qualifying hedges reduce earnings volatility in the income statement rather than amplifying it through mark-to-market volatility on non-designated instruments.

8. CONCLUSION AND RECOMMENDATIONS

This case study has critically evaluated the major domains of corporate finance through the analytical lens of Meridian Industries plc. Capital structure analysis confirms that Meridian's current gearing, at a post-downgrade Ba1 rating, is approaching the upper boundary of its optimal trade-off range — the tax shield benefits of leverage are increasingly offset by rising distress costs and constrained strategic flexibility. The WACC of 6.70%, whilst providing a useful hurdle rate, should be supplemented by divisional discount rates for projects whose risk profiles diverge from the firm's overall beta. Investment appraisal confirms Project NOVA as value-creating (NPV +£43.57m), with NPV decisively preferred over IRR for mutually exclusive project ranking. Dividend policy analysis cautions against a mechanistic cut, given the negative signalling implications; a scrip alternative deserves evaluation. Agency theory highlights governance vulnerabilities that inflate the cost of equity, and financial risk management through a coherent hedging programme directly supports Meridian's investment capacity and credit profile.

STRATEGIC RECOMMENDATIONS — MERIDIAN INDUSTRIES PLC

- 1. Implement a targeted de-leveraging programme:** Reduce gearing from 42% to a target range of 30–35% over 24 months through retained earnings allocation, minimising financial distress costs while preserving a meaningful

tax shield. This should improve credit metrics and restore investment-grade rating.

2. **Adopt Project NOVA (NPV rule):** Approve the renewable energy expansion based on its positive NPV of +£43.57m. Reject the Board's payback-period hurdle as the primary criterion; supplement NPV with scenario and sensitivity analysis for risk communication.
3. **Introduce divisional WACCs:** Commission a project to identify pure-play beta comparables for each of Meridian's three divisions, enabling risk-adjusted divisional hurdle rates that prevent cross-subsidisation of high-risk projects by low-risk divisions.
4. **Adopt a managed dividend approach:** Maintain the current dividend per share at £0.28 in the near term to avoid adverse signalling. Introduce a scrip dividend alternative for tax-sensitive institutional shareholders.
Communicate a formal dividend policy to reduce information asymmetry.
5. **Strengthen governance and remuneration alignment:** Restructure executive incentives to weight long-run TSR and ROCE targets over a three-to-five-year horizon, reducing short-termism. Appoint independent non-executives with capital markets expertise to the Audit and Remuneration Committees, consistent with FRC (2024) Code principles.

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