Q. Referring to page 23, lines 3-4: Please explain and illustrate why the use of an 86% debt ratio rather than an 80% debt ratio raises the equity return from 12.25% to 14.2% (instead of raising it to 17.5%).

A. The calculations are illustrated below. The calculations assume a constant cost of capital and a constant cost of debt plus guarantee fee. Hence, changes in the debt to capital ratio impact on the cost of equity.

(% debt)	(new debt cost plus guarantee fee)	+	(% equity)	(cost of equity)	=	cost of capital
(80%)	(7.75%)	+	(20%)	(cost of equity)	=	8.65%

Cost of Equity = 12.25%.

At 86/14 debt/equity, the calculation is:

(86%)	(7.75%)	+	(14%)	(cost of equity)	=	8.65%

Cost of Equity = 14.2%.