

Module 3 - Case

RISK AND RETURN, PORTFOLIO DIVERSIFICATION, AND THE CAPITAL ASSET PRICING MODEL; THE COST OF EQUITY

The Cost of Equity Capital and the CAPM

Part I

The cost of equity capital for a company is the rate of return on investment required by the company's shareholders. The rate of return consists of both the dividends and capital gains (e.g., an increase in the share price). The rates of return are expected future returns, not historical returns. Therefore, the returns on equity can be expressed as the anticipated dividends on the shares every year in perpetuity (stream of cash payments that never ends). Thus, the cost of equity is the cost of capital that will equate the current market price of the share with the discounted value of all future dividends in perpetuity.

To complete Part I of the Module 3 Case Assignment, review the background material on the capital asset pricing model, the material on the dividend growth model, and arbitrage pricing theory and do some of your own research using Internet search engines and the CyberLibrary. These models provide some insights and tools to estimate the rate of return that investors in our company "require" in the sense that if they don't see the possibility that they will earn that rate of return, they will sell the shares, and that of course will lower the market price per share.

These models use a set of assumptions that are not necessarily tenable.

You are asked by your board of directors to write a report explaining the challenge of estimating or coming up with a good "feel" for the "cost of equity capital" or the rate of return that you feel your company investors require as the minimum rate of return that they expect or require your company to earn on their investment in the shares of the company. There are several asset pricing models used to estimate the cost of equity capital that you have read about for this module in the background materials. After reading through the background materials, write a 5- to 6-page report for the board of directors (**of your SLP company**) by responding to the following questions:

Which of the three models (dividend growth, CAPM, or APT) is the best one for estimating the required rate of return (or discount rate) of your company? Based on your analysis and findings, what would you recommend to the board of directors of your SLP company?

In your paper, include discussion of the following issues:

- Ease of use of these three models.
- Accuracy of each of these three models.
- How realistic the assumptions of each model are.

For this paper you need to decisively choose one of these three models to defend to the board of directors.

Case Assignment

Part II

The cost of equity (discount rate) can also be determined by using the Capital Asset Pricing Model (CAPM). Calculating the cost of equity using the CAPM model is often more difficult than using the dividend discount model. The companies' financial statements do not show the cost of equity.

The following table shows necessary (hypothetical) information to calculate the cost of equity by using the CAPM model:

Company	Listing	R_{RF}	R_M	β_j
Nike Inc.	NYSE: NKE	0.40%	6.50%	0.90
Sony Corporation	NYSE: SNE	0.40%	9.50%	1.60
McDonald's Corporation	NYSE: MCD	0.40%	8.50%	0.40

$$E(r_j) = R_{RF} + \beta_j (R_M - R_{RF})$$

$E(r_j)$ - The cost of equity

R_{RF} - Risk-free rate of return

β_j - Beta of the security

R_M - Return on market portfolio

1. *Based on the above information, which company has higher cost of equity? Why? Briefly explain your reasoning.*

The CAPM model shows that risk-free rate of return, return on market portfolio, and company beta determine the cost of equity.

What type of factors influence company beta? Briefly describe the factors that influence company beta. For example, higher financial leverage (total liabilities to total assets ratio) can lead to higher company beta.

NOTE: Your report/assignment will not be accepted without proper citations and references. You must use the sources from the background material together with the sources you find on your own. It is also **required** that you answer all the questions related to learning outcomes.

Assignment Expectations

In the Module 3 Case Assignment, you are expected to:

- Describe the purpose of the paper and provide a conclusion.
- Answer the Case Assignment questions clearly and provide necessary details and calculations. The first paragraph should include a direct answer to the assignment question, with the body of the paper focused on defending your answer.
- Write clearly and correctly—that is, no poor sentence structure, no spelling and grammar mistakes, and no run-on sentences.
- Provide citations to support your argument and references on a separate page. Use APA format to provide citations and references [<http://owl.english.purdue.edu/owl/resource/560/01/>].
- Answer all the Case Assignment questions in an essay format. Do not type questions in the paper.
- Type and double-space the paper.

- Whenever appropriate, please use Excel to show supporting computations in an appendix, present financial information in tables, and use the data computed to answer follow-up questions. In finance, in addition to being able to write well, it's important to present information in a professional manner and to analyze financial information. This is part of the assignment expectations and will be considered for grading purposes.

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