Fin501 - strategic corporate finance mod 3 slp

Finance

Finance Module 3 SLP Assignment of the of the Finance Module 3 SLP Assignment The Cost of Equity Modern finance and investment books insist that the ultimate goal of all corporations is to maximize the wealth of their owners or shareholders. It is one thing to be successful and earn a profit, but this must translate into an increase in shareholder wealth. This is usually accomplished in two ways (1) through an increase in the market price of the stock and (2) through a return on investment in the form of dividends declared and paid out. Thus the shareholder gets a short term return through dividends and a long term return in capital gains when he decides to sell his portfolio in the stock market.

But we might wonder what determines the rate of return that a shareholder would want on a particular stock? It would depend for one thing on the price of the stock (highs, lows and average) and the historical trend of dividend payouts that has been made in recent years. Though every stockholder would have his personal thoughts and opinions on this, we can be sure that it would be higher than the risk free rate- the rate on US Government bonds maturing in one year and guaranteed by the Government. It would also depend on the Beta coefficient for that particular stock.

The Capital Asset Pricing Model

In fact a good estimate of the rate of return expected by a stockholder in relation to a particular stock would be given by the Capital Asset Pricing Model formula which goes as follows: $R_j - RF = \beta_j [RM - RF]$. By using this model, we can estimate the cost of equity or the rate of return that our companys shareholders require. Every financial manager must be aware of this because it will help to determine whether a particular course of action by the company will or will not add value to the shareholders. This is the

minimum rate of return and may be regarded as the cost of equity.

Obtaining the Cost of Equity for the Coca Cola Corporation, USA:

Reqd. Rate of Return = Risk Free Rate + Beta x (Market Return – Risk Free Rate)

Reqd. Rate of Return= 3% + 0. 49 x (10%-3%) => 3% + 0. 49(7%)

3% + 3. 43% = 6. 43%

Reflections on the Cost of Equity

Given that the average cost of capital for a firm in the S&P 500 is 10. 2 percent, I would have expected the Coca Cola Company to have a lower cost of capital than the average firm. This is because the Coca Cola Company is a good stock with consistency in performance and price. The price fluctuation for Coca Cola stock has not been too much, with a current price of $67. 46, a low of $61. 29 and a high of $71. 77 in the last 12 months (Yahoo Finance, 2012).

Comparing with Betas of Competing Firms

Now I will compare the Beta and compute the Required Rate of Return using the CAPM for Dr. Pepper and the Pepsi Corporation, two competing firms of the Coca Cola Corporation and in the same industry sector. For Dr. Pepper the Beta is 0. 74 and for Pepsi Corporation, the Beta is 0. 42 (Yahoo Finance, 2012). The required rates of return for each are computed as follows:

For Dr. Pepper: RRR= 3% + 0. 74(7%) => 3% + 5. 18% = 8. 18%

For PepsiCo: RRR= 3% + 0. 42(7%) => 3% + 2. 94 = 5. 94%

For me, it was a little surprising to note that for PepsiCo the required rate of return expected by an average investor would be 5. 94% which is less than the required rate of return for Coca Cola or 6. 43%, however this could be explained by the fact that Coca Cola is currently trading at $67. 46 while

PepsiCo is at $65. 41. Coca Cola has last paid out a dividend of $1. 88 giving a yield of 2. 8% while Pepsi has made a payout of $2. 06 giving a yield of 3. 1%. On the other hand, the required rate of 8. 18% seemed quite alright for Dr. Pepper stock, given its lower financial performance and stock price of $38. 29.

Finding the Cost of Equity using the Dividend Growth Model

The dividend growth model likewise assumes that the investor has certain expectations regarding the rate of growth of the stock, the capital gains and dividend yield at the end of a certain period. To find the cost of equity requiring the Dividend Growth Model would require making assumptions about the end stock price, the growth rate and the dividend payout for the period (Rao, 2012).

What I Have Learned in Module 3 SLP

From this module I have learned that while investors in the stock market may have differing expectations regarding the rate of return on a particular stock they have purchased, it most logically depends on the price of the stock, market volatility and the risk free rate at any given time. It also depends on the percentage of investment funds in a particular stock compared to the rest of their portfolio.

References

Rao, R. K. S. (2012). Fundamentals of Financial Management. Macmillan.

Yahoo Finance (2012). Stock Values and Performance Statistics for Coca Cola, Pepsi and Dr. Pepper.