

The cost of equity of my companyslp 3



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Cost of Equity Data Information The beta for my firm is assumed to be 1.5 = beta. (Yahoo Finance) Yield to maturity for federal funds = Risk free rate of return = 4.54% = R_f . (Federal Reserve).

Return on market portfolio = R_m

$R_m - R_f = 7\%$ (Given) $R_m = 11.54\%$

Calculation of Cost of Equity

Using Capital Asset Pricing Model,

Rate of Return = Cost of Equity = $R_f + \text{beta} \cdot (R_m - R_f) = 4.54 + 1.5 \cdot 7 = 15.04\% = \text{beta}(E)$

Calculation for asset beta: $\text{beta}(A)$

$\text{beta}(E) = \text{beta}(A) \cdot (1 + (1 - T) \cdot (D/E))$

$T = \text{tax rate} = 34\% = \text{given}$

$D = \text{market value of debt} = \text{USD } 136,288$ (Report, September 2007) (ARC)

$E = \text{market value of equity} = \text{USD } 815,151$ (Report, September 2007) (ARC)

$15.04 = \text{beta}(A) \cdot (1 + 0.66 \cdot (136,288/815,151))$

$\text{beta}(A) = 0.074\%$

The value of "asset beta" ($\text{beta}(A)$) represents the extent to which the company's business performance is related to the overall performance of the economy.

In the present case the value of asset beta is found out to be 0.074%, which means that the business performance of my company (ARC) will have 0.074% effect on the overall economy of the country.

The value calculated is very less which implies that the contribution of my company is only 0.074% to the overall economy.

Though my company is one of the largest real estate firms in the US, the effect on the financials of my company on that of the economy is very less.

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This would mean that the analysts and economists won't be very much interested in covering and following my company.

The value of asset beta can be increased either increasing the market value of equity or decreasing the market value of debt for my company. The value can also change with the changes in tax rate. The increase in tax rate will increase the value of asset beta of my firm.

Bibliography

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