Pg 389

(9-10)

Cost of Equity

The earnings, dividends, and stock price of Shelby Inc. are expected to grow at 7% per year in the future. Shelby’s common stock sells for $23 per share, its last dividend was $2.00, and the company will pay a dividend of $2.14 at the end of the current year.

1. Using the discounted cash flow approach, what is its cost of equity?
2. If the firm’s beta is 1.6, the risk-free rate is 9%, and the expected return on the market is 13%, then what would be the firm’s cost of equity based on the CAPM approach?
3. If the firm’s bonds earn a return of 12%, then what would be your estimate of r, using the own-bond-yield-plus-judgmental-risk-premium approach? (Hint: Use the midpoint of the risk premium range.)
4. On the basis of the results of parts a through c, what would be your estimate of Shelby’s cost of equity?