Chapter 13

7. Each of the six firms in the table below is expected to pay the listed dividend payment every year in perpetuity.

Firm Dividend ($million) Cost of capital (% /year)

S1 10 8

S2 10 12

S3 10 14

B1 100 8

B2 100 12

B3 100 14

1. Using the cost of capital in the table, calculate the market value of each firm.
2. Rank the three S firms by their market values and look at how their cost of capital is ordered. What would be the expected return for a self financing portfolio that went long on the firm with the largest market value and shorted the firm with the lowest market value? (the expected return of a self financing portfolio is the weighted average return of the consituent securities. Repeat using B firms.
3. Rank all six firms by their market values. How does this ranking order the cost of capital? What would be the expected return for a self financing portfolio that went long on the firm with the largest market value and shorted the firm with the lowest market value?
4. Repeat part ( c) but rank the firms by the dividend yield instead of the market value. What can you conclude about the dividend yield ranking compared to the market value ranking?