**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. Thus, the cost of equity is the cost of capital which will equate the current market price of the share with the discounted value of all future dividends in perpetuity.

To complete Part I of Module 3 Case Assignment, please 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 as well. 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 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 of 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 pages report for the board of directors (of your SLP Company) by responding to the following tasks:

*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:

1. Ease of use of these three models

2. Accuracy of each of these three models

3. How realistic the assumptions of each model are

For this paper you need to take a clear stand and pick one of these three models to defend to the Board of Directors. You cannot tell the Board of Directors that "I like all three models," they want you to come to them with a decisive choice of just one model.

**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 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 CAPM model:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Company** | **Listing** | **RRF** | **RM** | **ßj** |
| Nike Inc. | NYSE: NKE | 1% | 4.49% | 0.91 |
| Sony Corporation | NYSE: SNE | 1% | 6.83% | 1.48 |
| McDonald’s Corporation | NYSE: MCD | 1% | 2.94% | 0.36 |

**E(rj )= RRF + b(RM - RRF)**

**E(rj )** - The cost of equity

**RRF** - Risk free rate of return)

**ßj** - Beta of the security

**RM** - Return on market portfolio)

Based on the above information, which company has higher cost of equity? Why? Please explain your reasoning in brief.

*What do you perceive you have learnt in Module 3 Case Assignment? Please provide your evaluation of the Module 3 Case Assignment in brief.*