

Required

1. Determine the weighted average cost of capital based on using retained earnings in the capital structure. The percentage composition in the capital structure for bonds, preferred stock, and common equity should be based on the current capital structure of long-term financing as shown in Figure 1 (it adds up to \$18 million). Common equity will represent 60 percent of financing throughout this case.
2. Recompute the weighted average cost of capital based on using new common stock in the capital structure. The weights remain the same, only common equity is now supplied by new common stock, rather than by retained earnings. After how much new financing will this increase in the cost of capital take place? Determine this by dividing retained earnings by the percent of common equity in the capital structure (this is a slight variation from the formula in the book, due to an added dimension in the case).
3. Assume the investment banker also wishes to use the capital asset pricing model, as shown in Formula 11.5 in the text, to compute the cost (required return) on common stock. Assume $R_f = 6$ percent, β is 1.25, and K_m is 13 percent. What is the value of K_j ? How does this compare to the value of K_e computed in question 1?