

Cost of Capital (M&M, CO)

Next, we present the last balance sheet of M&M, CO (figures in millions of \$):

Assets	Liabilities	
	Current liabilities	19
	Long-term debt	50
	Common stock	36
	Retained earnings	20
Total: 125	Total:	125

There is also the following information available:

Long-term debt is formed by 50,000 10-year bonds, with \$1,000 face value and 5.5% annual coupon. These bonds were issued one year before at a 105% price and the current quote is 96%. The risk-free interest rate of the economy is 3.5%. The issuance of these bonds involved transactions costs of 0.5 million \$.

The face value of M&M's shares is \$2 with a current market price of \$8. The firm's dividend policy is to distribute all the net income as dividends. For the next year, we expect an EBIT of 20 million of \$. Dividend per share is expected to grow at a 2% annual rate forever. The firm's beta is 1.3 and we expect the stock market return to be 10%.

The company could raise a new loan with a bank paying a 5.75% annual interest rate. M&M pays a 30% tax rate.

- Calculate the cost of the current long-term debt.
- Calculate the cost of debt for the cost of capital calculations.
- Calculate the cost of equity, applying both the dividend discount model and the CAPM.
- Calculate the cost of capital of M&M using the cost of equity provided by the CAPM.