



# RAMA UNIVERSITY

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**FACULTY OF COMMERCE AND MANAGEMENT**

**COURSE: B.COM V SEM.**

**SUBJECT: INTRODUCTION TO FINANCIAL MANAGEMENT**

**SUBJECT CODE: BCH 505**

**LECTURE: 22**

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## LECTURE-22



### 3. Cost of Equity Share Capital:

The cost of the equity is the “maximum rate of return that the company must earn on equity financed portion of its investments in order to leave unchanged the market price of its stock.” The cost of equity capital is a function of the expected return by its investors. The cost of equity can be computed in the following ways:

**Dividend Yield method or Dividend / Price Ratio method:** According to this method the cost of equity capital is the discount rate that equates the present value of expected future dividend per share with the net proceeds of a share.

$$K_e = \frac{D}{NP}$$

OR

$$K_e = \frac{D}{NP}$$

Where,  $K_e$  = Cost of Equity Capital  
= Expected Dividend per share NP  
= Net Proceeds per share MP =  
Market Price per share

**Dividend Yield plus growth in dividend method:** When the dividends of the firm are expected to grow at constant rate and the dividend pay out ratio is constant this method may be used to compute the cost of equity capital.

$$K_e = \frac{D_1}{NP} + G = \frac{D_0 (1+g)}{NP} + G$$

Where:  $K_e$  = Cost of Equity Capital  
 $D_1$  = Expected Dividend Per Share at the end of the year  
NP = Net Proceeds per share  
G = Rate of Growth in dividends  
 $D_0$  = previous year's dividend

#### Earning Yield Method:

According to this method, the cost of equity capital is the discount rate that equates the present values of expected future earnings per share with the net proceeds of share.

$$K_e = \frac{EPS}{NP \text{ or } MP}$$

**Illustration 14:** The shares of a company are selling at Rs. 40 per share and it had paid a dividend of Rs. 4 per share last year. The investor's market expects a growth rate of 5% per year.

Compute the company's equity cost of capital;

If the anticipated growth rate is 7% per annum, calculate the indicated market price per share.

**Solution: (a)**

$$\mathbf{K_e = \frac{D_o (1+g)}{MP} + g}$$

$$= \frac{4(10.5)}{40} + 5\%$$

$$= 15.5\%$$

**(b)**

$$\mathbf{K_e = \frac{D_1}{MP} + g}$$

$$15.5\% = \frac{4 (1.07)}{MP} + 7\%$$

$$15.55 - 7\% = \frac{4.28}{MP}$$

$$MP = \text{Rs. } 50.35$$