
MBA 711 - Practice - Cost of Capital

Harrah's corporate bonds currently sell for \$875.24, pay a 8% semi-annual coupon, and mature in 26 years. Harrah's tax rate is 28%.

Harrah's preferred stock currently sells for \$24.50, dividends are paid at the rate of 9%, and the par value of the preferred stock is \$20.00.

Harrah Incorporated has common stock that currently sells for \$16.75 per share. Over the next year analysts estimate the S&P Index to return 12% and that the yield on Treasuries to be 5%. Harrah's expects EPS of \$3 per share this year ($EPS_1 = \3), Harrah's paid a dividend of \$1.80 last year ($D_0 = \1.80), and Harrah's has a growth rate on dividends of 5% that is expected to continue. The beta for Harrah's is 1.7. Based on comparable risk companies (A-rated), the premium for Harrah's common stock above corporate bonds is expected to be approximately 5%.

Harrah's Inc. can obtain funds for future investments through retained earnings, new issues of common stock, issuance of debt, and issuance of preferred stock. Management base their cost of capital on the following target capital structure: 40% debt, 5% preferred stock, and 55% common stock. Harrah's has \$375 million available in retained earnings. New issues of common stock are subject to flotation costs of 7%, a new issue of bonds are subject to flotation costs of 2%, and flotation costs on preferred stock is 4% .

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- A. What is your estimate of Harrah's after-tax cost of a new issue of debt?
 - B. What is your estimate of the YTM earned by investors that purchase Harrah bonds?
 - C. What is your estimate of Harrah's cost of new preferred stock?
 - D. Based on the DCF Method, what is your estimate of Harrah's cost of retained earnings?
 - E. Based on the CAPM, what is your estimate of Harrah's cost of retained earnings?
 - F. Based on the Bond Yield plus Risk Premium Method, what is your estimate of Harrah's cost of retained earnings?
 - G. What your estimate of the cost of new common stock for Harrah?
 - H. What is Harrah's breakpoint, where the cheapest combination of funds are exhausted?
 - I. What is Harrah's $WACC_1$, based on the cheapest combination of funds?
 - J. What is Harrah's $WACC_2$, based on the more expensive combination of funds?