

Practice Question: Cost of Capital

Question One:

On my Own PLC has the following capital structure in 2006:

	£' 000
▪ 1m Ordinary shares of £1 each	1,000
▪ 400,000 Preference shares of 50p each	200
▪ 7% Redeemable Debentures (£1 each)	200
Total	1,400

Additional Notes:

1. The ordinary shares have a current market value of £1.20 per share, and a dividend of 6p per share has just been paid. Dividend growth is expected to be at a rate of 12% per year.
2. The preference shares have a current market value of 60p per share and the rate of dividend is 8%.
3. The redeemable debentures have a coupon rate of 7% and a current market price of £94 per £100 block. These are redeemable in 8 years time.
4. Corporation tax rate is to be taken as 30%

Required:

- (a) Calculate the weighted average cost of capital for On my Own PLC using market values **(12 marks)**
- (b) Explain why it is considered preferable to use market values rather than book values when making this calculation. **(4 marks)**
- (c) Discuss the importance of gearing to a potential investor in some ordinary shares in On my Own PLC. **(4 marks)**

(Total 20 marks)