

Case 18. Southeastern Homecare- Cost of Capital
Guiding Questions (5th Edition)

1. What specific items of capital should be included in a corporate cost of capital estimate? Should historical (embedded) or new (marginal) values be used? Why?
2.
 - a. What is your estimate of Southeastern's cost of debt?
 - b. Should flotation costs be included in the cost-of-debt calculation? Explain.
 - c. Should the stated (nominal) cost of debt or the effective annual rate be used? Explain.
 - d. Any new long-term debt issued by the company will likely have a 30-year maturity. How valid is an estimate of the cost of debt based on 15-year bonds? If the estimate is not valid, how might it be adjusted to remove any bias?
 - e. Suppose the company's outstanding debt had not been recently traded. What other methods could be used to estimate the cost of debt?
3.
 - a. Why is there a cost associated with retained earnings?
 - b. What is the company's estimated cost of equity using the capital asset pricing model (CAPM) approach?
 - c. Why is the T-bond (Treasury bond) rate used to proxy the risk-free rate rather than the T-bill rate?
 - d. How can the market risk premium be estimated?
4.
 - a. Use the discounted cash flow method to obtain a cost-of-equity estimate.
 - b. The firm, over the last few years, has had a 20 percent average return on equity and has paid out about 50 percent of its net income as dividends. Under what conditions could this information be used to help estimate Southeastern's expected future dividend growth rate?
5. What is your final estimate for Southeastern's cost of equity? Explain your answer.
6. What is your estimate for Southeastern's corporate cost of capital?
7.
 - a. Estimate the divisional cost of capital for each Southeastern division assuming that both divisions have the same optimal (target) capital structure. (Hint: Use the CAPM to produce a cost of equity for each division, and assume the same corporate tax rate and debt cost for each division.)
 - b. Discuss how differential debt capacities could be incorporated into the divisional costs of capital.
 - c. Is the divisional cost of capital applicable for all projects within that division? Explain.
9. Using your answer to Question 8a and the data in Exhibit 16.2, estimate the cost of capital for the **home care division** of an average not-for-profit hospital. How much confidence do you have in the cost of capital estimate?
10. What are Southeastern's book value and market value weights of long-term debt and equity? Which set of weights should be used in the corporate cost of capital estimate? Why?