Assignment 17

Project-Specific Cost of Capital

The purpose of this assignment is to practice estimating a project-specific cost of capital, and also to calculate your firm's two components of beta (operational risk and financial risk). For the first part, use the data below for Sundoes. For the latter part, use the firm that you've been following throughout the course.

Group:

Section:

1. A chain of coffee shops would like to diversify its business operations by branching out into the copy shop business. Calculate the appropriate hurdle rate (i.e. project-specific WACC) for the project using the following information:

    - The firm is in the 34% tax bracket and has a debt-to-capital ratio of 35%.
    - The copy shop investment will be financed with 25% debt and 75% equity.
    - The market risk premium is 8%; the risk-free rate is 5.5%; the firm's cost of debt is 7%.
    - The two closest pure plays in the copy shop business have the following financial characteristics:

Comparable	**Equity Beta**	**Debt-to-Equity**	**Tax Rate**
Kinks	1.10	1.13	0.30
Zippy's	1.25	1.27	0.35

2. Fill in the table below and use it to compute the *unlevered* beta of your firm.

Ticker	
Equity Beta	
Debt (short-term + long-term debt)	
Equity (market capitalization)	
Debt-to-Equity	
Tax Rate	
Unlevered Beta	

Is most of the beta risk born by shareholders is due to financial risk?