

MINICASE DIVISIONAL COST OF CAPITAL

A recent annual report for Diageo PLC explains that its investments are expected to generate cash returns that exceed its "long-term cost of capital," which Diageo estimated to be approximately 10%. Diageo has three main lines of business: food items, such as Haagen Dazs ice

cream; alcoholic beverages, such as Seagrams; and restaurants, such as Burger King. Diageo did not report costs of capital separately for these three businesses. Information from the annual report is given here, followed by relevant market data.

Financial information:

Cash and marketable securities	\$1,498 million (approximates market value)
Short-term debt	\$706 million (approximates market value)
Long-term debt	\$8,509 million (\$8,747 million market value)
Common shares outstanding	788 million
Year-end share price	\$55.875
Income tax rate	34%

Market data:

Diageo's beta	1.00
Diageo's long-term borrowing rate	6.75%

Riskless returns:

Short term	5.13%
Intermediate term	5.50
Long term	6.00

Market risk premium:

Short term	8.40%
Intermediate term	7.40
Long term	7.00

The following table provides information concerning publicly traded restaurant firms.

FIRM	STOCK LISTED	BETA	TOTAL DEBT (\$ MILLIONS)	PREFERRED STOCK (\$ MILLIONS)	COMMON SHARES (MILLIONS)	CLOSING STOCK PRICE
Applebee's	NASDAQ	1.30	28.5	—	31.0	\$22.750
Bob Evans Farms	NASDAQ	0.95	54.7	—	42.3	19.000
Brinker International	NYSE	1.70	104.7	—	72.1	15.125
CKE Restaurants	NYSE	1.15	86.7	—	18.4	16.000
McDonald's	NYSE	1.00	4,820.1	411.1	694.0	45.125
NPC International	NASDAQ	0.80	81.4	—	24.5	7.250
Shoney's	NYSE	0.90	440.4	—	41.5	10.250
Wendy's International	NYSE	1.15	147.0	—	103.4	21.250

QUESTIONS

1. Diageo subtracts the value of its portfolio of short-term investments, which is held outside the United States and is not required to support day-to-day operations, from its total debt when calculating its "net debt ratio." Use Diageo's net debt ratio to calculate Diageo's overall WACC.

- Should Diageo use its overall cost of capital to evaluate its restaurant investments? Under what circumstances would it be correct to do so?
- Estimate the cost of capital for Diageo's restaurant businesses.
- Explain why there is a difference between Diageo's overall cost of capital and the cost of capital for its restaurant businesses.