

ON THE VALUE OF TWO STAGE DIVIDEND GROWTH MODELS FOR IMPROVING THE ELEMENTARY PEDAGOGY OF COST OF EQUITY CAPITAL DETERMINATION

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ABSTRACT

Elementary finance texts often use the Gordon dividend growth model to determine the cost of equity capital (CEC). They seldom include more general two stage (high, then lower) growth models, because they may appear too complex. We compare the two-stage DCF model and the Fuller-Hsia (1984) H-model (which has a simpler formulation) in a sensitivity analysis and show that for moderate first stage growth rates and durations, the two models give similar results for CEC. Using the H-Model, we derive simple expressions for the temporary (supernormal) growth risk premium and beta. Because it is so easy to use, we recommend that textbooks should include the H-model as another method for CEC determination.