Volume 3, Section 1 – McShane, Cost of Capital

Q. (Appendix E, page 3) In the paragraph in the middle of the page, is Ms. McShane suggesting that the Canadian economy growing at a nominal annual rate of 4.75%, as opposed to 5.4%, will have no negative impact on the ability of her low-risk sample industrials to generate book equity returns going forward? If so, please justify this apparent insensitivity of industrial returns to the pace of economic growth.

A. There are factors other than domestic GDP growth that impact the level of profitability, including economic growth abroad (since companies' operations are increasingly global in scope). World growth can be expected to be stronger in the future than historically. Corporate tax rates are expected to be lower in Canada than in the past, which should have a positive impact on after-tax rates of profit. The average combined federal/provincial corporate tax rate in 1994 was close to 45%; in 2008/2009 it is expected to be approximately 34%. Assuming corporate profits increase by close to 7% annually over the long-term, an increase in earnings per share of 7% with 50% of earnings retained in the business is sufficient to maintain an earnings level of 12.5%.