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ESTIMATING COST OF EQUITY IN THE RESTAURANT INDUSTRY: THE INFLUENCE OF INDEX AND VARIABLE SELECTION

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ABSTRACT

Estimating the required rate of return for a project is a challenging issue that is on the agenda of almost any hospitality manager (Olsen, West, and Tse, 1998). The motivation of this paper is to assess the performance of the various cost of equity variables and the influence of market index selection on the cost of equity estimates in the restaurant industry. The observation period of this study is between 2000 and 2004 and the sample entailed 81 restaurant firms. Three market indices Equal Weight Return Index of CRSP (EWCRSP), Value Weight Return Index of CRSP (VWCRSP), and Standard & Poor's (S&P) 500 and five cost of equity variables Fama-French (three variables) momentum (UMD), and liquidity were used in this study. In all instances, the Fama-French (FF) model resulted in a significant R^2 change over the CAPM which showed that the two Fama-French variables (SMB and HML) explained some extra variance over and above the CAPM. The full five-variable model performed worse than the FF model for all market indices. As a result, it is recommended that restaurant executives/entrepreneurs use the FF model by averaging the cost of equity estimates of the three market indices.