

10.6: Estimating the Cost of Preferred Stock

The cost of preferred stock is found through the following equation

$$k_p = \frac{D}{P_0} = \frac{(\text{par value})(\text{dividend rate})}{P_0}$$

Where

k_p represents the cost of preferred stock financing

D represents the dividend on preferred stock (alternatively found by taking the par value times the dividend rate on the preferred)

P_0 represents the current price of the preferred stock

Note that here (as with other costs), we are merely solving for the investors' required return on preferred stock as their return is the firm's cost of financing from preferred. One common mistake students sometimes make here is to use the common dividend instead of preferred. Be careful to use the right dividend. Another common mistake is that when this formula is applied, the answer comes out as a decimal (8% would be 0.08). Assuming you are plugging the other costs in as percent, make sure you do the same with this. You can't enter the cost of debt as 6 (for 6%) and the cost of preferred as 0.08 (for 8%)...you need to be consistent.

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