



Major determinant of the cost of capital

Regardless the type of capital, the main determinant of cost is the required return for investors.

The required return must be met to entice market participants to place funds in the firm whether the security is debt, preferred stock, or common stock.

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Only the cost of debt needs to be adjusted.

 Interest payments (the amounts paid to debtholders) are tax deductible.

 Dividend payments (the amounts paid to preferred and common stockholders) are not deductible.











Example Problem

BBB's bonds have a par value of \$1,000, a maturity of 25 years, and an annual coupon rate of 12%. Investors will expect an 11% rate of return for these bonds. The flotation costs will equal 4% of the market value of the bonds. The firm's marginal tax rate is 40%. What is the true cost of the bonds?

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What's the cost of preferred stock?
The current price is \$111.10 with a par of \$100 and a 10% dividend.
Flotation costs are 5% of the price.

$$\begin{aligned} \kappa_{p} &= \frac{D}{V_{p} - F} \\ \kappa_{p} &= \frac{0.10(100)}{111.10 - (0.05)(111.10)} \\ \kappa_{p} &= 0.09475 = 9.475\% \end{aligned}$$













 Opportunity cost: The return stockholders could earn on alternative investments of equal risk.

 They could buy similar stocks and earn k_s, or company could repurchase its own stock and earn k_s. So, k_s is the cost of retained earnings.

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What's the DCF cost of common
equity, k_s? Given: D₀ = \$4.19;
P₀ = \$50; g = 5%.
$$k_{s} = \frac{D_{1}}{P_{0}} + g = \frac{D_{0}(1 + g)}{P_{0}} + g$$
$$= \frac{$4.19(1.05)}{$50} + 0.05$$
$$= 0.088 + 0.05$$
$$= 13.8\%.$$























 For all purposes, the cost of capital for the firm should be estimated based on the target percentage of funds expected to come from all sources.

 This is true even if a particular project is financed with only one type of funds.















































Would what the company planned to do with the money it raised have any effect on the WACC?

 It might. We have implicitly assumed that the company would invest in assets with equal risk as existing assets.

 If the company planned to invest in riskier assets, this would raise the cost of capital.





 NO! The composite WACC reflects the risk of an average project undertaken by the firm. Therefore, the WACC only represents the "hurdle rate" for a typical project with average risk.

 Different projects have different risks. The project's WACC should be adjusted to reflect the project's risk.





